Consolidating the Constraint of Islamic Financial Principles in the Development of Saudi Arabia’s Financial Market.

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Abstract: The development of the Saudi financial market represents an institutional revival and re-adaptation of Islamic economic principles into modern capital market. Along a broad spectrum of culture and theology, the products and service that emerged from different levels of harmonisation, restructuring and consolidation of the Saudi capital market is a potential area that exposes and also consolidates the gaps that have historically divided Islamic financial system and financial systems of the western world. In comparative discourse, the development of Islamic financial systems like that of Saudi has been a model in the field of research that is driven by legal pluralism, and the cross-fertilization of different legal traditions, both Western and non-Western. Hence, it stands at the intersections of law and economics and of Religion and politics. Within this grand framework, one witnesses an International financial regime that is evolving and often defined by the retracting of financial products and services that open the way to contain modern challenges and expand on the orthodox paradigm of law and economics of the Islamic communities. This paper highlights the challenges and opportunities that are present in this territory of consolidation and expansion.

1. INTRODUCTION
The role of financial markets in enhancing the economy of nations is an aspect that scholars have covered so widely. This expectation of an economic institution capable of attracting investments and consolidating growth was a transformation that saw a global renaissance during the 1950s and 1960s, bringing a new paradigm to the areas of financial econometrics and regulatory endeavours. This was followed by the globalisation of industries in the 1980s, which brought financial markets closer across borders. Nations continued to empower their financial institutions for the competitiveness that emerged from that era. This regional and continental connectivity of financial markets also brought a deeper sense of interdependence, as industries turn to conglomerates operation in different continents.

Many countries, especially in Europe, benefited tremendously from the opportunities of financial market economy that saw the proliferation of different kinds of products and service. In the period of this development, countries like Saudi were mainly mono-economies that rely mainly on energy product exportation.

2. DEVELOPMENT OF SAUDI ARABIA’S FINANCIAL MARKET
Saudi began to explore the opportunities for diversifying its economy to include capital market strategy around 1984 when the Fifth Development Plan started gathering momentum. This plan heralded a new era for Saudi in its quest to have a robust financial industry that is not solely reliant on oil. This was an extension of earlier concepts such as the Islamic Development Bank (IDB) that was founded in 1973. In the following years, the Saudi Industrial Development Bank (SIDB) was established as a specialised credit institution. This drive saw, for the first time, professional stakeholders and private sector involvement in the country’s economy.

The major challenge began when it became apparent that for Saudi to tap into the global financial market, there is the need to join global organisations such as the World Trade Organisation (WTO). The result was a far-reaching legal and institutional reforms, some of which were negotiated in 2005 as part of the process to comply with being a member of the WTO. Again, numerous bilateral agreement were signed into legally binding documents in line with the International Organization of Securities Commissions (IOSCO) standards. These decisions had to be taken for Saudi to fulfil its strategic scheme to develop and expand its capital market for the opportunities that the global financial market offers. The remodelling of what was seen as less-than-standard domestic regulations also became an imperative part of this new drive.
Although evidence suggests that Saudi has a long-standing legal proposal prior to joining the WTO, i.e., the finance lease law, the real estate mortgage law, the law on supervision of finance companies, etc., joining the WTO came with new requirements. Paradoxically, these requirements, have their ambiguity in relation to the ethical and religious underpinning of Islamic law, which is the principal source of law and jurisprudence in Saudi. The major concern was the impermissibility of financial products that involve elements of gambling, usury and uncertainty. Islamic financial law is strict on any transaction that will lead to usury. Farroq argues that the definition and prohibition of usury, especially when the scope is broadened into all aspects of modern economy (including interest in a competitive, regulated environment) is a daunting task. Osmany, for instance, argues on this complexity from the perspective of the complexity and ‘risk factor’ associated with the growth of mass marketing, which brings the need for specialised establishments to deal with such a globalised phenomenon. Moreover, most large financial institutions are often not owned by individuals, but the accumulated wealth of investors. It, therefore, becomes difficult to distinguish between interest-based facilities from non-interest ones. Furthermore, it is not allowed to invest in financial products that will be reinvested in business that include alcohol and pork, which is also a difficult aspect unless there is transparency in the question or reinvestment of an investors capital.

As these issues become a point of concern for Islamic jurists, they were constrained to examine and scrutinise the different kinds of products and service that were about to hit the market as Saudi was poised to introduce financial products that will attract both domestic and foreign investment. But many of these financial products that are available in western capital markets were either complex in nature or have characteristics that do not conform to the requirements of Islamic financial principles. The distinctions were mostly a reflection of the difference in moral obligations on ownership and transfer of products and assets as well as the manner of partnership and profiteering. Yet, one can also safely argue that there are areas of convergence between the two, i.e., issues of consent in a contract and the rejection of manipulation of the market. There are also grey areas where Islamic financial experts appear to have divided opinions.

The unanimous view is that for a product to pass the litmus test of Islamic law compliance, it is required that real assets must back finance. This conventional position was among the key reasons that generated the attention of Islamic jurists to embark on observing the nature and character of these products and services with the view of subjecting them to independent reasoning (Ijtihad) and scrutinising areas where they can be restructured within the permissibility of Islamic Law. Leading scholars such as Jabeen and Khan maintained insisted that to fulfil the requirements under Islamic law, products must be backed by real assets, and their returns should also not be linked and benchmarked to the conventional money market instruments. This is in clear contrast to Western finances that have complex contracts such as the Credit Default Swap. The absence of these complex transactions was among the reasons why Islamic banks are seen as more stable and safer. Part of the ambition of Saudi was to open the financial market to equity and other products, with strict exception to western oriented debt based products.

Though hindered by the limitations due to the inclination to Islamic law principles, the following years saw an increase in domestic demand for Islamic financial products on one hand and efforts to attract international investors on the other. The first challenge for domestic investors was the lack of well-established financial laws to deal with contracts such as Takaful. Which is a co-operative system of reimbursement from funds contributed by individuals or companies for to compensate any party who suffers loss or damage. There was also the absence of sufficient mortgage facilities that comply with Islamic laws, especially with issues of real estate where demand for owning houses by the citizens was high. This led to a new thought on enactment of mortgage laws that will allow for Sukuk bonds, as well as the issuance of micro and macro credit and finances for mortgages. Yet, this was also challenged by the lack of a well-developed financial regulatory body and indeed the non-integration of standards such as Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI), the Islamic Fiqh Academy (IFA), etc. These continued to obstruct the amount of domestic investment in the Saudi capital market.

The underlying principle of Islamic finances had always been that all transactions either of property or finances must be fair, and should be based on commensurate share of equity by all parties. Even at the helm of divergent opinion among Islamic scholars, ‘equity’ and ‘fairness’ remained a unanimous position. The differences in opinion were mainly with regards to issues around secondary sources of Islamic law such as Ijtihad, which was used in the restructuring some modern financial products to conform to Islamic law
that first emerged in Saudi Arabia where the concept of Tawarruq, which is a financial instrument in which a buyer purchases a commodity from a seller on a deferred payment basis and the buyer sells the same commodity to a third party on a spot payment basis, is a concept that first emerged in Saudi Arabia where the prevailing school is the Hanbali School of Islamic jurisprudence, which is also the only classical prevailing school is the Hanbali School of Islamic jurisprudence, which is also the only classical school that has explicitly approved the concept of Tawarruq.

The development of then Saudi financial market also faced the struggle to balance the demands of consumers and the need for expansion and diversification of the financial market on one hand, and the need to comply with Islamic principles on the other, bearing in mind the fundamental principle of Islam that when one intends to exchange a commodity for another, he should sell his own commodity and use the proceeds to purchase the other instead of bartering in commodities that differ in quality. This position was meant to avoid situations where one of the parties would be subjected to an unfair deal. The principle also insists that where an exchange is involved, the value of the product has to be proportionate to the one exchanged. Scholars such as Jabeen and Khan noted that the striking part of this ruling is the weight of importance given to standardisation of commodities, which is also an important concept of quality management.

One of the most central point of all the issues around the transplant of different products and services into the Saudi capital market is perhaps the issues of Usury (Riba). Usury is not only a major area of concern for Saudi; it is an aspect that resonates in every discourse regarding the permissibility or otherwise of any contract in Muslim majority countries as it is a principal factor under the guiding aspects of Islamic law. This underlying area brings about the resistant to allow all sorts of western models of financial products into countries like Saudi, without ensuring that they do not usher in products and services that promote usurious transactions. What Islamic finances allows, on the other hand, is for a lender to purchase from the market and sell to a customer through which he or she can make a profit. This system, however, varies depending on whether the contract is a Murabahah, which is a form of ‘trust sell’ in which the seller purchases an item for a specified profit margin payable to the seller, or Musharaka, which is a return on equity partnership where parties contribute to financing the business and then share the profit or loss on a pre-agreed ratio according to each parties equity participation. The third most common of this type of permissible contract is Ijarah (lease contract), where an intermediary, often a financial firm, purchases an asset and leases it to a client for fixed termly payments. Sometimes, this type of contract comes with the option for the lessee to buy the asset at the end of the contract. Although these are contracts similar to what is found in other conventional markets around the world, the Islamic system prohibits any form of usury in the conduct of these contracts.

The opening of the market to new products ignited a new kind of debate on how to harmonise the new products and services to conform with Islamic laws on finances. This led to the exploration of the nature and dynamics of the various finances in the conventional markets around the world and how they can be replicated without offending the strict positions of Islamic laws of finance. To achieve this, features of traditional Islamic finance became a major point of reference. Reforming the existing framework to meet International standards as well as keeping the norms of Islamic law to attract domestic consumers was a major challenge. This according to Vogel and Hayes is a project that requires ambitious innovation. The first step was the development of clear laws and initiatives to include “developing doctrines governing the creation and regulation of an Islamic public financial market.”

The concepts of adherence with common Islamic principles existed side by side the desire to make the Saudi market attractive to foreign investment. To achieve this, a well-articulated corporate governance initiative that is significantly closer to international standards was established, foremost of which was the Capital Market Law (CML) and the Capital Market Authority (CMA). In line with these standards and in consonant with Islamic financial principles, the Saudi system insisted on certain key things, which included transparency, accountability and fiduciary responsibility. Islamic scholars were also unanimous that any financial system must abide by the ethics and moral standards that disallow insider trading and market manipulation and excessive exposure to financial risk. The later, i.e., exposure to excessive financial risk was undoubtedly one of the key reasons for a number of banking and financial meltdowns seen over the years across the western
hemisphere.34

One of the initial areas of contention among experts in Saudi was over the kind of model to be adapted. While some proposed a United States type model as one that will accelerate growth,35 others highlighted the need to have a deeper scrutiny of the distinct socio-economic and political features of the society,36 as well as the significance of cultural norms in pursuing any economic model.37 Yet, it is evident that the resolve to move the financial industry forward prevailed, leading to the establishment of the Saudi Capital Market (Tadawul), which opened to qualified foreign investors.38 The initial capitalisation of the project was around $528bn,39 which exceeds the combined capitalisation of all Gulf Cooperation Council (GCC) stock markets combined together. The ambition according to the Chairman, Khalid Al-Rabiah, was to attract both foreign and domestic investors.40 The volume of trade at the Tawadul reached an average of $2.4bn per day across 162 listed companies.41

The expansion of the Tadawul saw the growth of other products including mutual funds that are compliant with the rule of Islamic finance.42 Although questions of risk and return were at the centre,43 the industry has continued to grow along the growth of industries in other gulf nations, ensuring that globally, the size of Islamic compliant assets has reached between $400 to $500 billion.44 Recent figures indicate that Islamic banks operating in over 75 countries have an estimated asset of $300 billion with an annual growth rate exceeds 15 percent.45 The value of the industry as of 2010 is in the excess of $1 trillion.46

In the midst of this growth, the perspective of Islamic economists has remained resolute against usury and insisting on profit and loss-sharing models, which are both prevailing concepts of Islamic economics since the second half of the last century.47 Based on the idea of 'form over substance', Islamic finance has become a profitable segment of the global financial industry.48 It is also important to stress that in areas of banking, Islamic principles are quite different from conventional banking as deposits are interest-free. In other forms of finances and contracts, the avoidance of usury, gambling and uncertainty have remained prominent.49 Zaher, for instance, pointed out that the "direct correlation between investment and profit differentiates Islamic banking from conventional or western banking, which defines maximisation of the shareholders’ wealth as the sole objective of the firm."50

The resistance to accommodate all types of western products and service has to some degree affected the growth of the Saudi capital market within the realm of an ever expanding and interconnected global market.51 Yet, this principle has also helped in ensuring that investors in Saudi are not exposed to excessive risk as against their counterparts in western financial markets. Hence, some Islamic economist argue that the principle of Islamic finance is capable of ensuring the stability of the international economy.52 This is because, in contrast to western style finances, Islamic finance is keen on ensuring due diligence in monitoring the investments and does not allow unsecured debts that may later affect the borrower.53 As Siddiqui argues, Islamic principle on the allocation of funds to investment insists on clear profit and loss model, on tangible assets and also on the soundness of the project and not on speculative adventures. Also, in order to kerb inflation, money supply should not overstep the supply of commodity.54 Moreover, it is not permitted under Islamic law to investing in any fixed income securities or any other financial security that promises a guaranteed return.55

Other areas of distinction between Islamic finance and its western counterparts is are the questions of moral obligation and the manner of transferability.56 Maintained throughout history, the right of ownership of property has been central to Islamic economics, particularly within the jurisprudential concept of al mu’amalat.57 i.e., which allows one person to transfer lawfully, the ownership of his belonging to another in many ways including financial transactions under clear and honest terms. However, certain exceptional grey areas have evolved as a result of changes in the nature of financial markets and the proliferation of new products that are complex, e.g., debentures, bonds, commercial paper, etc. The unsettled question on trading in these financial instruments is because they are seen as debt-based securities that have the potential of some form of usury.58 Methodological reasons and difference of opinion have left Islamic scholars in a long discussion on these financial instruments.59

3. CONCLUSION
The continuous globalisation of the capital market and the need to attract more foreign investment means that the Saudi capital market would continue to explore the possibilities of expansion while trying to keep with the orthodox concepts of Islamic finance. Hence, the essence of diversification and innovation is also constrained by the need to abide by religious tenets. In the face of growing global competition comes the challenges of keeping up with the demand of consumers for more products and often more
liquidity. Hence, the continued willingness of economists in the Islamic world to explore innovative alternatives to different products and services while drawing extents and limits from the prevailing provisions of Islamic law. The motivation to do this could be attributed to the growth of the Islamic financial industry as well as its growing around the world.

As evidence shows, the growth and expansion of Islamic finance, especially Islamic banking have now reached global growth rates of 10-15 percent per annum, as it continuous finding new footing even in western financial systems with over 51 countries around the world having Islamic banks. As a result of this consistent growth, the area of scholarship is ripe for further research and debate on the structure of emerging products and how they fit into Islamic financial systems. Amidst these reforms, challenges and growth, the Saudi capital market being situated in the largest economy in the Gulf region will continue to be a model for Islamic financial products.

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