Islamic Finance Ethics and Shari’ah Law in the Aftermath of the Crisis: Concept and Practice of Shari’ah Compliant Finance

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ABSTRACT. As its name suggests, Islamic finance is based on a religious worldview and is thus often considered to be ‘ethical finance’ per se. It is expected to observe the prohibition against interest (riba), uncertainty (gharar) and gambling (maysir), and it is supposed to tie financial transactions to activities in the real economy and share entrepreneurial risks. Proponents of Islamic banking claim that it is therefore superior to conventional finance regarding efficiency, justice and stability. The practice of Islamic banking, however, has reduced potentially substantial differences to actually subtle distinctions in the contractual basis of financial transactions. The replication of conventional products – including functional equivalents for complex structured products similar to those that contributed to the recent financial crisis – took place with the approval of prominent scholars on the Shari’ah boards of Islamic financial institutions. The said Shari’ah scholars see themselves more as legal advisors than as guardians of business ethics. Their micro-legalistic approach (‘Shari’ah compliance’) is very different from the macro-systemic perspective of Islamic economists who have been developing models of interest-free and profit and loss-sharing economies since the second half of the last century. But with ‘form over substance’ in practice, Islamic finance has become a profitable segment of the global finance industry. In its present form, it is neither more ethical nor more efficient or stable than ‘prudent’ conventional banking. This could change in the future. The Islamic finance industry might respond to a growing demand from the public for more ethical banking and socially responsible investment and to the increasing concerns of some regulators in relation to more genuine Shari’ah based financial innovations with an explicit ethical profile and a consistent link to the real economy.

Keywords. Shari’ah, Islamic finance, ethical banking, finance ethics

I. INTRODUCTION

The financial crisis started in the US as the result of a deregulation of the banking industry, political interventions in the housing market...
for low income citizens and a change of the course of monetary policy after a long period of extremely low interest rates. Subprime loans were bundled, tranchéd and transformed into securities and traded globally. These securities lost their value when the underlying loans became non-performing. The global placement of subprime papers induced the global spread of the crisis and a global rescue operation of unprecedented scale. For many people the crisis has revealed fundamental faults of our capitalist system, where greed has become the driving force in finance and where governments have been captured by banks too big to fail. A general feeling is that excessive profits had been pocketed by top executives and shareholders while losses were covered by taxpayers’ money. In response, many people have called for the enforcement of moral standards in finance, tighter regulations, and a prohibition against unsocial and speculative practices with potentially huge losses for society.¹

Such views were expressed both in Western societies – in particular among proponents of socially responsible investments and ethical banking – as well as in Muslim countries.² They formed the backdrop of a sympathetic attitude towards Islamic finance in these circles. Although general awareness thereof is not very deep, it is commonly understood that Islamic finance has a religious background that serves as a kind of ethical compass for finance. The prohibition against interest is well known, but Islam also prohibits certain ‘anti-social’ practices such as gambling and excessive risk taking. This should tie finance to the real economy and prevent extreme leveraging and the emergence of a huge overhang of financial over real assets. Finally, a unique feature of the corporate governance structure of Islamic banks is the Shari’ah board, which ensures the Shari’ah compliance of all products and processes of the Islamic bank. Proponents of Islamic finance and Islamic economics go one step further and assert that Islamic banks exhibited greater resilience in the recent crisis than conventional banks, and they claim that this is due to the observance of ethical standards and specific prohibitions. In short: the global financial crisis has proven that Islamic finance is more efficient, stable and just.³
Although first glance evidence supports this claim, a more detailed assessment will call it into question:

(i) The alleged superior resilience has to be put into the right perspective.
(ii) Although conceptually different, Islamic finance replicates in practice conventional finance.
(iii) Western banks have penetrated Islamic finance. For them Islamic finance is not a matter of religion or ideology but a profitable business opportunity. Their structuring departments develop functional equivalents of complex derivative products with only very weak links with the real economy.
(iv) Shari’ah board members emphasize their role as legal advisors (instead of guardians of morality), and most products of reverse financial engineering have found the approval of some prominent Shari’ah scholars.
(v) Islamic finance as such is not ethical finance per se, it only excludes a limited number of businesses from the investment universe (related to pork, alcohol, pornography, etc.) and screens financial ratios in order to keep exposure to interest below a pragmatic threshold. But Islamic financial institutions generally do not use positive lists to define the profile of desirable activities and target sectors for their financing and investment.

Islamic finance is not the superior system it is presented to be by its proponents. Nevertheless, Islamic finance has a potential for development: it is a relatively young business, and it often operates in an unfriendly environment (with respect to taxation, regulation, monetary policy, public opinion, etc.). It has to compete with powerful global players, and it suffers from a human resource shortage. Growing uneasiness with and critique of the conventionalisation of Islamic finance today may lead to some new initiatives in the future. Governments and regulators of some countries are prepared to play a more active role and to support innovations in substance.

II. PERFORMANCE OF ISLAMIC FINANCE IN RECENT YEARS

It would be correct to say that Islamic banks performed better than those conventional banks (in particular investment banks) that were highly leveraged and deeply involved in speculative trading activities. Most of the
largest global players fell into this category. But what is often ignored is the fact that besides Islamic banks a large number of conventional banks were likewise only slightly affected by the first round of the crisis (2007-2008) that brought down the iconic investment banks. Many banks in emerging markets with limited international exposure also fared relatively well (e.g. Turkey, Thailand and Malaysia), and European banks with a strong deposit base, prudent lending policies, no speculative trading activities and a strong regional commitment remained resilient. Most Islamic banks share these economic characteristics, which can explain the resilience of both Islamic and conventional banks in the first round of the crisis.

In the second round of the crisis (from 2009), however, Islamic financial institutions were also hit. A working paper produced by the IMF (Hasan and Dridi 2010) found for a sample of Islamic and conventional banks that the profitability of Islamic banks was better than that of conventional banks in 2008, but after a sharp decline in the profits of Islamic banks, the picture reversed in 2009 in most countries. While Islamic banks avoided default, bailouts and restructurings nevertheless took place. Some of prominent cases include The Investment Dar (Kuwait; see Parker 2011), Gulf Finance House (Bahrain; see Khnifer, Baig and Winkler 2010), Islamic mortgage providers Tamweel and Amlak (Dubai; see Parker 2009) and the intervention of the government of Qatar to prop up seven banks, including the two Islamic banks (Anonymous 2009).

When the US government bailed out Citigroup and AIG, it also saved their Islamic businesses. Finally, it should be noted that there were more than 20 Sukuk defaults (see Khnifer 2010). In summary, and in the words of two representatives of a law firm located in Dubai: “The idea that Islamic finance instruments somehow offered protection from the wider global financial crisis has generally proven to be false. On the contrary, the market for Shariah compliant financial products appears to have been hit hard by the economic doldrums” (Kalantar and Delaney 2010).

There are other cases which illustrate – irrespective of the global crisis – that Shari’ah compliance alone is neither a shield against economic
problems nor a guarantee of commercial success. The Islamic Bank of Britain was initially not successful. It started as a retail bank, but out of a Muslim population of 2.5 million in the UK, the bank attracted only 50,000 customers (2%), and the cumulated annual losses would have wiped out the equity of the bank. It was rescued by a capital infusion of £20 million by Qatar International Islamic Bank (Amin 2010). Another example is the growth of Islamic finance in Malaysia. It is rarely noted that it relies heavily on the public sector; only 20% of the total Islamic deposits are held by private individuals, but 50% by the government and other financial institutions (Shanmugam 2010) and Sukuk issues enjoy tax privileges compared to conventional bond issues.

What also became apparent during the recent crisis is the lack of established procedures for the restructuring of ailing Islamic finance arrangements. Instruments for the recovery or resolution of products and institutions have been introduced on an ad hoc basis, and most bank insolvency laws were deficient or non-existing in many jurisdictions. Finally, the crisis revealed a considerable legal uncertainty in cases of default in relation the priority of claims and the status of ‘investment deposits’.

III. THE REPLICATION OF CONVENTIONAL INSTRUMENTS AND PRODUCTS

Islamic finance has to observe the prohibitions of

(i) *riba*, i.e. interest on loans
(ii) *gharar*, i.e. avoidable uncertainty in transactions
(iii) *maysir*, i.e. gambling

The early models of an Islamic economy assumed a replacement of interest-bearing loans and deposits by a system of profit and loss sharing (PLS) both in the financing and the ‘deposit’ business of Islamic banks. The basic idea was that banks provide finance to entrepreneurs and projects on the basis of PLS (known as *mudaraba*, if only one partner – the
bank – provides the capital, and musharaka, if both partners contribute the capital) while savers participate in the bank’s profits or losses instead of receiving fixed interest. Profit-sharing ratios (percentages of the profit for the contractual partners) can be determined according to demand and supply, but they must be specified at the beginning of the transaction and cannot be altered afterwards (e.g. to take account of business developments). Losses must be borne in proportion to the capital shares of the investors (in the case of mudaraba by the bank alone, in the case of musharaka by both partners).

Nowadays, Islamic financial market models are based on a broader spectrum of investment and financing instruments, including low risk forms of finance and debt instruments permissible under Shari’ah law. Debt instruments that had initially been neglected in theoretical models became the most important tools of Islamic banks in practice.

**From Real Asset Financing to Shari’ah Compliant Structured Products**

Although the Quran prohibits taking interest on loans, it explicitly encourages trade and approves trade profits. Suppose borrowers do not require liquidity ‘as such’ but as a means to purchase merchandise, raw materials, machinery etc., or to pay for services. In all these cases a conventional bank loan can be substituted by an arrangement whereby the bank acts as an intermediary and acquires the desired objects on the client’s behalf, pays the supplier directly, and sells these objects on to the client for a fixed mark-up on the purchase price. The client pays at a later date either in a lump sum or in instalments. The bank’s fixed mark-up is a functional equivalent to interest in economic terms, but it is legally a profit from trade. Thus it is not affected by the prohibition of riba which relates to loans. Trade operations (known as murabab) differ in several respects from loan transactions (particularly with regards to liabilities and risks), meaning that the boundaries between permissible trade profits and prohibited loan interest are legally quite clear (Rahman 2010).
It must be emphasized that Shari’ah is Islamic law (and neither economics nor ethics) and thus any judgments concerning the legitimacy of transactions is based on legal (and not on economic or ethical) criteria. Islamic economists searching for an economic rather than a legal alternative to interest, neglected (quite rightly so from their point of view) debt financing techniques based on intermediary trading since they – although legally permissible – did not move the system any further along in economic terms when compared to the status quo of interest-based finance. But for the management of an Islamic bank, the systemic dimension is not a major concern. In countries where regulatory provisions are weak, levels of transparency are low, business ethics are poor, and political and economic elites are closely interwoven, financing based on PLS harbours enormous risks for the bank. For entrepreneurs who are more interested in the bottom line of their balance sheet than in Islamic values, it is attractive to find a partner who shares the losses of risky transactions, while sharing expected profits is less appealing. There is much to indicate that PLS financing systematically attracts above-average levels of risk without guaranteeing above-average profits. In practice, therefore, Islamic banks tended to focus on (debt) financing on the basis of trade agreements (murabahah) and other permissible rental or leasing transactions (known as ijara) with predetermined profit margins for the bank.

Murabahah transactions tie the financing business of banks to activities in the real economy. Since banks hold debt contracts until maturity on their balance sheets, they will monitor the performance of their clients. Furthermore, banks’ potentials for high leverage or speculation are very limited. A Shari’ah compatible banking system based on murabahah may not meet the PLS ideal of Islamic economists, but it would serve the real economy without high leverage and the volatility of conventional finance. To this extent, claims of superiority would be justified.

However, the evolution of Islamic banking did not stop at simple murabahah transactions because the holding of debt contracts until maturity, the absence of leverage and the close tie between the bank’s income
and the performance of its clients in the real economy are not benefits but burdens from the perspective of a profit-oriented bank. Islamic banks, therefore, soon started to develop types of transactions that overcame these restrictions. The toolbox of Shari’ah compliant debt financing has been refined and extended in two directions: towards the provision of liquidity to clients at fixed costs irrespective of their specific asset needs, and towards raising funds from the capital market by issuing ‘Islamic bonds’ (see below).

Islamic banks can provide liquidity at fixed costs in a Shari’ah compliant manner by combinations of trade contracts (Arbouna 2007). In the ideal world of Islamic economists, banks provide liquidity only on the basis of PLS. But the implied uncertainty with regard to the costs and returns of financing make PLS unattractive for Islamic banks (even if one ignores all the control problems mentioned above). A straightforward method to overcome this uncertainty would involve two compensatory trade transactions: the bank’s client sells an object to the bank for immediate payment by the bank and immediately repurchases it from the bank at a mark-up for deferred payment by the client. This is a blatant circumvention of the prohibition of *riba*, and it is identified and prohibited as such by Shari’ah. The legal verdict is different, however, if not only the bank and its client but three or four parties are involved in a transaction with the same economic result and a more complicated set of contracts. The basic structure is as follows: if the bank’s client is primarily interested in liquidity and not in a commodity provided by the bank, he or she can buy a commodity from the bank on deferred payment basis for 110€ in one year and resell it to another party for the immediate payment of the actual market price of 100€. As a result, the bank provides a commodity (worth 100€) in exchange for a claim for a payment (of 110€) in the future and the client resells the commodity in exchange for a payment (of 100€) today and an obligation for a higher payment (of 110€) in the future. Neither the bank nor the client holds the commodity. The bank has used an input of 100€ today and will earn a trade profit of 10€ in one year. The client has received cash of 100€ today and will have to

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pay 110€ in one year, i.e. the costs of funding are 10%. It is crucial for the Shari’ah qualification that the client did not receive the liquidity from the bank but from a third party. The bank has thus earned a legitimate trade profit. The reselling of a commodity is not an issue for the bank’s client if the commodity is traded on a well-organized exchange – such as platinum on the London Metal Exchange. Islamic banks make good use of this exchange. The basic structure of the combined trade contracts is widely used in different versions (known as tawarruq or commodity murabahah) by Islamic banks both for financing transactions with non-banks as well as with other banks for liquidity management purposes.\textsuperscript{13}

A further ‘breakthrough’ in contractual engineering was achieved by the introduction of unilateral promises (\textit{wa’d}) into financing arrangements.\textsuperscript{14} Since promises are unilateral declarations of intent and not bilateral contracts, they are not subject to the restrictions of contract law (especially with respect to gharar). The combination of sales contracts with promises has facilitated the creation of a wide range of Shari’ah compliant options, including hedging techniques, swaps, plugs, and short selling arrangements.\textsuperscript{15} Such innovative instruments are still subject to debate among scholars (and sometimes also with regulators), and they are not yet generally applied. But their wider acceptance and the use of existing prototypes is probably only a matter of time. This is particularly the case for instruments that were developed with an active involvement of recognized supranational bodies. Prominent examples include (i) the Tahawwut (Hedging) Master Agreement which was introduced in 2010 by the International Islamic Financial Market (IIFM) in cooperation with the International Swaps and Derivatives Association (ISDA) to facilitate Shari’ah compliant profit-rate and currency swaps for hedging purposes, and (ii) IIFM’s efforts to engineer a Shari’ah compliant alternative to repos as a liquidity management tool for Islamic banks.\textsuperscript{16}

It should be noted that many of these new tools of the Islamic finance industry are replications of conventional instruments that were held responsible for excessive leverage, speculation and risk taking, and
thus for the systemic crisis. In view of the arsenal of new Shari’ah compliant tools under development, the claim of a higher systemic stability and efficiency now appears rather shaky (Ahmed 2009).

From Asset-Backed Securities to Trading Financial Contracts

The second direction in the development of Shari’ah compatible products is the design of tradable securities that resemble fixed-interest securities in their economic character but are legally equity-based as they incorporate ownership rights. So-called sukuk (Islamic bonds) are created when companies or governments looking for finance for a fixed period of time transfer the ownership of assets that generate a stable income stream (e.g. from long-term rental) to a special purpose vehicle (SPV). The SPV then issues certificates on the capital markets equal to the value of the assets transferred; these certificates give the holders the right to a share in the securitized income stream. This income stream often comes from the original owner of the object who leases it back from the SPV (similar to a conventional sale-lease back arrangement). The claim to the income stream should be derived from the fact that the certificates constitute (partial) ownership of the SPV’s assets from which the income stream is generated. This requires a true transfer of the ownership title from the originator of the sukuk to the SPV and the certificate holders respectively. In this instance, the certificates may be traded without restriction as Shari’ah compliant equities. In reality, however, many sukuk do not involve the true transfer of ownership; only the usufruct (the right to the income stream) is transferred but not the asset itself. The difference becomes clear in instances where the sukuk issuer (the SPV) becomes insolvent or files for bankruptcy. In the case of ‘real’ title deeds, the holders can hope to recover part of their capital through the sale of the asset. But the capital is lost completely if the certificates only represent the right to the income stream that has dried up. Another important difference is that from a Shari’ah perspective sukuk of the ‘usufruct type’ are considered not as equity-like but as debt-like papers that are not tradable; they must be held to
maturity. In general, *sukuk* representing tangible assets or proportionate ownership are tradable, while *sukuk* representing receivables are non-tradable.

In reality ‘mixed’ or ‘hybrid’ *sukuk* can be found. Their income is only in part derived from actually transferred assets, while usufruct rights and receivables are the basis for the remaining part of the income. There are various reasons for only partial transfers of full ownership, ranging from a lack of a sufficient quantity of suitable assets to cumbersome (costly and time consuming) procedures for the transfer of full ownership rights. Hybrid *sukuk* are tradable if the tradable components constitute more than 50%.

Early *sukuk* have been criticized for diluted ownership rights, but also for a buy-back guarantee by the issuer for the certificates at face value (i.e. the issuing price of the *sukuk*) at maturity. This price guarantee implies that a *de facto* interest-bearing instrument has been created. While buy-back guarantees as such are permissible, prices must reflect the actual market value of the assets at the time when the buy-back becomes effective. But if the buy-back was transacted at the actual market prices at maturity, this implies considerable uncertainty with respect to the rate of return of a *sukuk* compared to an interest-bearing bond because the market value at maturity is not known at the time of issue of the *sukuk* and may decrease over time.

Initially, banking tools and capital market products were developed separately, but recent tendencies indicate a convergence. A better integration of banking and capital market instruments could allow Islamic banks to replicate a change of the basic business model that took place in conventional investment banking over the last decade, namely from ‘originate and hold debt contracts’ to ‘originate and sell-off (asset backed) debt-like contracts’. This, however, would be a very mixed blessing. It may enhance the efficiency and profitability of Islamic banks (calculated in conventional terms such as return on equity), but it also implies a host of adverse selection and principal agent problems. It is by no means a guarantor for more systemic stability, less speculation and more equitable distribution of risks and returns – on the contrary: the sell-off approach was a main ingredient in the subprime crisis.
From Investment Accounts to Quasi-Deposits

It is not only the financing business of Islamic banks or the product design for capital markets where a closer look at actual practices and recent developments reveals a significant discrepancy between conceptual (or ideological) claims and realities of the Islamic finance industry, a discrepancy can also be observed in the ‘deposit business’ of Islamic banks.

Like conventional banks, Islamic banks offer two different types of accounts: demand deposits for transactional purposes (ATM, cheques, transfers, etc.) and investment accounts for savings purposes (to earn a financial return on paid-in funds).

In conventional banking, the underlying contracts for both types of accounts are basically the same, namely loan or deposit contracts that oblige the bank to return the money received in full (either on demand or after a specified period, with or without interest), irrespective of the results of the use the clients’ funds by the bank. In many jurisdictions, deposit insurance schemes protect (in full or partially) the claims of the depositors in the event of a bank default.

In Islamic banking, the Shari’ah compliant contracts underlying demand deposits and investment accounts are fundamentally different. Demand deposits are based on a deposit or loan contract (qard), which is very similar to its conventional counterpart. The depositor is not allowed to receive any direct return on the deposited amount, but he or she may enjoy, for example, payment services free of charge. Demand deposits in Islamic banks can be protected by a third party guarantee (such as a deposit insurance scheme). Investment accounts are based on a partnership or joint venture contract (mudarabah) where one party (the saver and the investment account holder respectively) provides the funds managed by the other party (the bank). Profits resulting from investments are shared by both parties according to a profit sharing ratio negotiated and fixed when entering into the contract. The absolute amount of profit and thus the return on capital is known only at the end of the investment period. Should the investment...
end in a loss, it has (conceptually, not necessarily practically) to be borne by the fund providing party, i.e. the investment account holders. The bank will forego its expected profit share, but has no further obligation to compensate the investment account holders (except in cases of misconduct or negligence). Conventional banks do not offer an equivalent to investment accounts; the closest conventional proxies are (shares in) mutual funds.

Proponents of Islamic finance have always been very critical of rentier capitalism: capital owners can earn a risk-free income from lending their capital against interest without any entrepreneurial efforts. This is considered unjust, and risk-free capital returns fall under the prohibition of *riba*. Capital gains are permissible only if the capital owners are willing to take a risk. As a consequence, savers who want a return for their money must be willing to expose their funds to an investment risk.

But customers of Islamic banks who are familiar with conventional banking products may have a different view: they take investment accounts as substitutes for interest-bearing savings or term deposits. In practice, this perception of customers is echoed by most Islamic banks: they do not emphasize the conceptual differences, but try to satisfy the expectations of the customers and treat investment accounts like savings or term deposits. It is a widespread practice that Islamic banks advertise ‘expected rates of return’ for investment accounts. These rates are usually close to the interest rates for conventional deposits, and Islamic banks apply techniques that bring the realised rates in line with the advertised rates. They smooth out the profits by building up or drawing down investment risk reserves and profit equalisation reserves (which are recognized as Shari’ah compliant both by AAOIFI and IFSB [IFSB 2010]). This means that an individual investment account holder participates in the profits generated by the investment of his or her own money plus some portion of the profits generated by previous account holders (if reserves are drawn down), or that he or she has to give up some of the profits of his or her funds for future account holders (if reserves are built up). If the reserves are insufficient to beef up the disbursed ‘profits’ (i.e. income from investments plus liquidation of reserves) to the
level expected by the investment account holders,\textsuperscript{21} then shareholders can (or have to) abandon parts of the profit shares due to them.

Such practices blur the Shari‘ah substance of investment accounts and can only be justified by the pragmatic argument that Islamic banks compete with conventional banks for funds from customers who see investment accounts as close substitutes for savings and term deposits. If such a view prevails, investment account holders ignore the inherent risks of their contracts. Islamic banks take advantage of this by offering rates of return that only match the interest paid for risk free conventional deposits, i.e. they get risk sharing funds without paying a risk premium (although the risk sharing qualities may only become relevant in cases of investment losses that exceed reserves and voluntary reductions of the bank’s profit share).

As long as investment account holders get the return they expect, they do not have a strong motivation to worry about the opaqueness of Islamic banks and to urge the management for more information on the risk exposure of their funds. Nevertheless, for conceptual reasons Islamic banks should disclose to the investment account holders, for example, their general investment objectives and policies as well as business strategies and risk-sharing policies, the sources of returns paid out to investment accounts (actual investment income, release of investment risk and profit equalisation reserves, reduction of the profit share of the bank). Without transparency, market discipline cannot be effective.\textsuperscript{22}

Investment accounts are often treated by regulators as deposits, and they require from Islamic banks investment account protection by a deposit insurance scheme. But deposit insurance schemes protect accounts only in the case of a bank failure. They cannot shield them against losses from poor investment performance. If a conventional bank suffers heavy losses on its asset side, this may cause a bank failure because of fixed deposit liabilities. In contrast, an Islamic bank can pass on losses from the asset side to the liability side of the balance sheet (after all mitigating techniques are exhausted). This would save the Islamic bank from bankruptcy, but reduce the value of the investment accounts, i.e. cause losses

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for the investment account holders. The deposit insurance would not become effective as long as the bank is not bankrupt.

If investment account holders were aware of this, rumours of an expected passing on of losses to the investment accounts could be sufficient to induce a bank run. Deposit insurance is only a remedy for bank runs in the conventional banking system (where losses cannot be passed on to the depositors), but not in a Shari’ah compliant system. This implication is often overlooked and hardly reflected in the capital requirements for investment accounts. Capital requirements should be higher for Islamic banks than for conventional banks, not despite of but precisely because of the loss-sharing capacity of investment accounts. When the deposit insurance is ineffective, only tier 1 capital can absorb losses and prevent or stop a bank run.

In sum, actual practices and potential risks hardly support claims of inherently higher levels of fairness in the treatment of depositors/investment account holders, and of superior stability properties.

IV. THE GAP BETWEEN MACRO-CONCEPTS AND MICRO-REALITIES

The number of media reports on the practice of Islamic banking has increased over the last years as well as the number of industry specific publications with critical comments by insiders on the ‘conventionalization’ of Islamic finance. Macro concepts had located Islamic finance in the broader context of more comprehensive economic and social systems. The micro realities of most Islamic banks are characterized by competition between conventional and Islamic finance in mixed capitalist systems with a dominant conventional sector.23 Many people are disappointed that the major differences between conventional and Islamic finance seem to be in form only and not in substance: financing the same kinds of projects with the same kinds of partners on roughly the same commercial terms (but on a different legal basis) will not add a new quality to the economic development of the Muslim world. What is also a major concern
is the fact that Shari’ah compliant products and techniques can have the same economic characteristics as interest-based conventional instruments in all relevant critical dimensions.

Criticism of the reduction of Islamic finance to a formalistic examination of Shari’ah compliance is not new, although its intensity has grown over the last few years. This raises the question as to why earlier criticism had little if any effect, and why Islamic banks continued to adopt instruments that many people find objectionable from a conceptual or systemic perspective. If one does not assume ignorance or ill-will on the part of chief executives and capital owners, one has to look for inherent forces that have pushed the Islamic banking industry towards financial deals with weak or no links to productive assets or entrepreneurial activities in the non-financial sector. What led to form over substance?

The expectancy of systemic superiority in an Islamic financial system goes back to the writings of Islamic economists. The earliest publications in this field did not originate from Shari’ah scholars of leading Islamic universities in the Arab world, but rather from academics in Asia. Beginning in the 1930s, efforts among Indian Muslims to create a Muslim state on the territory of British India after Britain’s withdrawal gave rise to an intense debate on the Islamic economic system. The state of Pakistan was created in 1947 as a ‘Muslim nation state’. It nevertheless had a secular character and many questions relating to the Islamic economic system had not been answered. The constitution of 1958 turned the state into the Islamic Republic of Pakistan, but this did not terminate discussions on economic policy that had been going on since the 1940s. Instead, it intensified the search for a system that could be a third way between interest-based capitalism and godless communism, based on principles found in the Quran and the Sunna. It was expected that such a system would be different from what was known until then and drive forward economic development. Most of the early treatises on Islamic economics (up to the 1960s), which are reprinted and still cited today, were written against this background. Similar discussions also took place in the
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Arab world in association with the withdrawal of European colonial and mandatory powers from the middle of the 1950s, but without the context of the formation of an ‘Islamic’ state.

The Islamic banks that have emerged since the second half of the 1970s (initially in the Arab world, since the 1980s also in Asia) had a completely different background. They were set up in order to provide all the financial services that the business community already knew about and took advantage of, but in a Shari’ah compliant manner. These banks were for-profit enterprises, and since Shari’ah compliance is a juristic category, the initiators did not strive after a change of the economic system, but sought rather a different legal underpinning of their actual businesses within the established system. Nevertheless, economists’ arguments of systemic superiority were often taken up by representatives of Islamic banks in keynote addresses and media appearances, and this created the impression that concept and practice were in harmony.

During the last decade, conventional banks have made a substantial contribution to the growth of the Islamic finance industry both in quantitative terms and with respect to the structuring of products. Conventional market players – including global players such as Citibank, HSBC or PNB Paribas – have set up Islamic windows or subsidiaries or converted the whole business of existing banks to Shari’ah compliance. Capital owners of conventional banks do not enter into the Shari’ah compliant business for the sake of Islam – particularly not if they are non-Muslims from foreign countries. They penetrate this market because they see profitable business opportunities or threats to their present conventional business. Islamic banks are not charitable or developmental institutions, but for-profit enterprises. The executives, directors and staff of Islamic windows, subsidiaries or converted banks are usually well-versed in conventional banking, including commodity, currency and securities trading within the financial sector. Even if they take recourse to Shari’ah compliant forms for their business and use the conceptual rhetoric of Islamic finance, they will not ignore the fact that conventional
banks have earned exceptionally high profits not from financing the real economy (i.e. non-financial enterprises), but from trading financial contracts within the financial sector (i.e. with other financial institutions).

Before the crisis, double digit trading profits had become the benchmark for the banking industry worldwide. The higher profitability of trading financial contracts compared to the returns on the financing of non-financial ventures is an attraction not only for conventional banks but also for Islamic banks – provided tradable financial contracts can be structured in a Shari’ah compliant manner. Islamic banks with a toolbox confined to ‘plain vanilla’ instruments for the direct financing of non-financial ventures have been unable to exploit the intra-industry trading opportunities. Experts in structuring with a conventional background took the lead and designed a large number of ‘advanced’ products for the Islamic banking industry. It is somewhat misleading to call these new products ‘financial innovations’, since most were developed through a process of reverse engineering, starting from established conventional products. What the engineers modified were not the commercial characteristics, but the contractual basis of conventional products and techniques. Thus the result is less a financial and more a ‘contractual’ or ‘legal’ innovation. There was no particular ethical or ideological justification for these products. They are deemed necessary in order to improve the efficiency and competitiveness of Islamic finance, measured in terms of profitability.

V. Formalism and Shari’ah Governance

The gap between macro concepts and micro realities seems to be perceived as a problem by Islamic economists, external observers and even some bank practitioners, but hardly by Shari’ah scholars. This may be due to the fact that Shari’ah scholars are first and foremost experts in law who have been trained in micro-textual methods and ways of thinking. Only 20% of the top 100 Shari’ah scholars (scholars with the largest numbers
of Shari’ah board memberships) have a degree in economics or finance in addition to their Shari’ah qualification (Ünal 2011, 27).

But suppose Shari’ah scholars were to take a macro-systemic look at the actual state of affairs in Islamic finance and acknowledge that form has more importance than substance. Although they would share the diagnosis of the critics, they may draw very different conclusions. If Islamic finance has to compete with conventional finance in mixed systems then it is important for the success of Islamic institutions to have attractive products and efficient procedures. This is particularly true if the majority of bank customers expect functional equivalents for all known services from the Islamic finance industry (including, for example, house financing, credit cards, and hedging operations) but are not willing to pay a significant premium for the Shari’ah compliance of Islamic bank products and services. In such a setting it is plausible to work first on a Shari’ah compliant replication of well-established products used by the majority of customers (innovation in form without a new substance) before considering the development of products with a new form and substance (i.e. with Shari’ah compliant, innovative risk/return profiles) that are initially appealing only to a smaller number of customers. There are no compelling arguments why Shari’ah board members should reject such a management strategy. Consequently, the management can expect that board members will act as legal advisors and contractual engineers in order to produce formally correct solutions for the products and techniques required by the management.

But conceptually, Shari’ah boards should also be supervisory bodies of sorts, to ensure stakeholders that all products and procedures are Shari’ah compliant – especially in jurisdictions where no national Shari’ah authorities have been established and no external Shari’ah audits are required. The supervisory function requires a considerable degree of formal and factual independence from the management and a willingness to take a critical look at the Shari’ah qualities of products and procedures. It is very doubtful, however, whether board members who themselves
have designed a product in the first instance will have enough distance for an unbiased assessment of its Shari’ah qualities afterwards. Incentives for critical assessment are particularly weak when previous consultancy services were generously rewarded. Rewards may not only take the form of a direct payment, but may take the form of a continuation of a Shari’ah board membership which has a high value for the respective scholar – be it in financial terms or with respect to recognition and reputation.\textsuperscript{27}

Corporate governance standards for Shari’ah boards have been published or drafted by several reputable institutions, including AAOIFI,\textsuperscript{28} IFSB,\textsuperscript{29} Bank Negara Malaysia\textsuperscript{30} and Hawkamah (Hawkamah Task Force 2010).\textsuperscript{31} AAOIFI, for example, explicates that Shari’ah board members, “should be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with independence, objectivity and integrity.”\textsuperscript{32} IFSB recommends that the number of Shari’ah board memberships should not become too large to ensure that sufficient time and attention is allocated to the affairs of each institution.\textsuperscript{33} It is further recommended that Shari’ah boards shall be composed of senior and junior members with different lengths of experience, and that members should represent different schools of jurisprudence and different nationalities.\textsuperscript{34} Islamic financial institutions “shall specify and adopt a process for assessing the effectiveness of the Shari’ah board as a whole, as well as the contribution by each individual member to its effectiveness.”\textsuperscript{35}

A confrontation of these recommendations with the practice of Shari’ah boards in most jurisdictions (with Malaysia as the outstanding exception) reveals striking differences. For 370+ Islamic financial institutions with a total of 1141 Shari’ah board positions and 280 scholars, the top 20 of the scholars (7.1\%) hold individually between 14 and 85 and as a group 621 board memberships (54.4\%), while the remaining 260 scholars (92.9 \%) hold individually between 1 and 11 and as a group 520 board memberships (45.6\%) (Ünal 2011, 12). This indicates that board memberships are seemingly very attractive, and it raises serious doubts as to whether sufficient time and attention can be allocated to all institutions.
The nurturing of young scholars is still an exception and by no means the rule. The composition of Shari’ah boards seems to be guided more by a desire for homogeneity than diversity of schools of jurisprudence and nationality. Board compositions have a strong country bias,[36] and performance assessments of Shari’ah boards and individual board members are virtually non-existent.

Another concern regarding transparency and accountability has been expressed by IFSB: “More often than not, a majority of Shari’ah boards […] mention in their Shari’ah pronouncements/resolutions only whether a transaction […] is permissible or non-permissible. Rarely […] do they make available supporting evidence” that could be examined by others. “As a result, it is very difficult to improve public awareness in terms of understanding the basis of and justifications behind a Shari’ah pronouncement/resolution.”[37]

Finally it should be noted that many prominent Shari’ah scholars with large numbers of Shari’ah board memberships in commercial Islamic financial institutions can also be found as members of Shari’ah boards of regulators such as the Central Bank of Bahrain, the Securities Commission of Malaysia and Bank Negara Malaysia or the State Bank of Pakistan, and of rating agencies, including the International Islamic Rating Agency which offers, inter alia, Shari’ah quality ratings for Islamic financial institutions. Such a constellation where Shari’ah advice is given by the same individuals to the regulated and rated institutions on the one hand and the regulators and rating agencies on the other is neither in conformity with Western governance standards nor with the standards and guidelines of AAOIFI and IFSB.

In sum, the actual practices of the Islamic finance industry deviate substantially from recommendations and best practice examples put forward by institutions such as AAOIFI, IFSB and Hawkamah. Overburdened Shari’ah boards and Islamic law scholars will neither have a sufficient capacity nor a strong motivation to extend the scope of their activities beyond the legal realm into ethics and macro-systemic analyses.
V. Islamic Finance, Socially Responsible Investing and Ethical Banking

Providers of funds increasingly take an interest in the use of their funds, i.e. in the projects and transactions in which their funds are employed. In the conventional sector, this has given rise to movements such as socially responsible investing (SRI), ethical banking or green (environmentally conscious) banking. Religious communities have always played a promoting role in these movements. They have grown into a rapidly expanding and well-structured segment of the Western financial industry (Chami, Cosimano and Fullenkamp 2002; Nicholls and Pharoah 2008). The Report on Socially Responsible Investing Trends 2010 has identified 3.07 trillion US$ in total assets under professional management in the United States that use at least one of three socially responsible investing strategies: the incorporation of environmental, social and governance (ESG) factors into investment analysis and portfolio construction, the filing or co-filing of shareholder resolutions on ESG issues, and deposits or investments in banks, credit unions, venture capital funds and loan funds that have a specific mission of community investing (SIFF 2010, 10). It is worthy of note that the SRI volume in the US alone is roughly three times the estimated size of the global Islamic financial services industry.38

It has become popular among Western financial institutions (and other enterprises) to subscribe to charters of good governance, social responsiveness and corporate citizenship (EU 2001; Crane et al. 2008; UNEP 2006; 2008). Islamic financial service providers have to be careful not to fall behind the secular West (where the current financial crisis has given a fresh impetus to ethical finance).

What is more important than the rhetoric of socially responsible investing is actual business practice. As demonstrated above, the ethical substance of many if not most Shari’ah compliant products and transactions could be improved substantially. Financing and investment decision in Islamic finance and in ethical finance are structurally similar insofar as
both use a two-tier filter to define the spectrum of permissible options. In both cases the first tier filter is a negative list (a ‘black list’), excluding all those businesses that are related to prohibited activities such as child labour, human rights violations or ecocide in the case of ethical finance or pork, alcohol or gambling in the case of Islamic finance. The second-tier filter is of a very different nature.

(i) In ethical finance the second-tier filter is a positive list (“white list”) which defines preferential areas for financing and investment, i.e. activities that are to be supported such as projects in community development, poverty alleviation or renewable energy. (ii) In Islamic finance the second-tier filter is another negative list. Its purpose is not to focus investments on desired sectors or activities but to prevent the extensive ‘pollution’ of investment returns by interest elements. It is a composite financial filter that becomes relevant when banks or mutual funds invest in listed stocks. It sets threshold levels for interest-related financial ratios, and only stocks of companies whose ratios do not violate the thresholds can be included in the portfolio of a bank or a fund. Generally, the accepted threshold levels are not very restrictive, i.e. they leave a rather large number of stocks at the disposal of the asset managers. The financial filters do not give any further guidance on the desirability of stocks, and asset managers will usually decide on the basis of the expected financial performance (without a prior ‘ethical’ screening).

To sum up: Shari’ah-compliant finance is not *per se* ethical finance. Explicit ethical screening procedures or techniques have not been reported for most of the businesses of Islamic financial institutions. However, one should not rush to draw conclusions from such an observation. The conventional system provides finance for ethically more and less desirable projects and enterprises. Since not only ethically desirable but also ethically neutral (socially not harmful) activities are necessary for the proper functioning of the economy, it would be rather naïve to demand that only selected beneficial activities should be financed. Therefore ethical banking is not identical with but only a (small) segment of conventional finance. The same should hold true for Islamic finance, but the problem here is that the reference to religion by the label ‘Islamic’ gives rise to the expectation
that each and every financed activity must be ethically desirable. This cannot be the case, and it must be accepted that Islamic financial institutions are also engaged in ethically neutral activities. Islamic finance has to overcome a terminological dilemma: To speak of ‘ethical Islamic banking’ sounds like a pleonasm, but ‘ethically neutral Islamic banking’ looks like a contradiction in itself. A solution to this dilemma might be the replacement of ‘Islamic’ by ‘Shari’ah compliant’ when related to ethical finance.

**VI. Conclusions**

The observance of Islamic law does not automatically create ethical banking or socially responsible investment. The prevailing legalistic approach does not even prevent the engineering of functional equivalents for those structured conventional products that have been held responsible for the reinforcement and global spread of the financial crisis. Fortunately, most of these products are still at the prototype stage and have not yet been widely used in Islamic finance.

There is growing disappointment concerning ‘form over substance’ in the media and among practitioners and academics. But at the same time some committed regulators have expressed their concerns. After Islamic finance has reached a certain size and level of technical efficiency, they would like to see more genuine financial (and not only contractual) innovations. The increasing number of conference contributions and papers on topics such as the role of Islamic finance in poverty alleviation or the developmental impact of Islamic micro finance in general and micro equity and micro *takaful* (Shari’ah compliant alternative to insurance) in particular is encouraging. The risk/return characteristics and market potentials of innovative forms of participatory finance are being explored, and even far reaching concepts for a banking sector reform (along the lines of what was proposed as ‘100% money’ or ‘narrow banking’ for conventional finance) are topics on internet forums (such as IFB NET) and in industry journals.
Islamic finance is a continuously evolving industry. The evolution may take a new turn if more and more customers of Islamic banks realise that their banks act very much like conventional banks with nothing more than a green wrapper. Muslim customers receive returns and are charged fees and mark-ups that are Shari’ah compliant functional equivalents to conventional interest. They find it increasingly difficult to understand why these returns and charges are legitimate profits, while their functional equivalent in the conventional system – interest – is so strictly prohibited. In the past – and often based on the unrealistic PLS models –, economists had explained the prohibition of *riba* by the pronouncement of ethical superiority, greater justice, social responsibility and better stability. But such arguments are not convincing if major systemic differences in substance cannot be seen. Customers who became sensitized to normative issues and social impacts in the aftermath of the financial crisis may look for alternatives to conventional banking – and they may find ethical banking and socially responsible investment in the conventional sector more appealing than conventionalized Islamic finance, even if transactions are interest-based. This would intensify the competition between Islamic and conventional finance in a particular segment, and it could pose a serious threat to Islamic banks. But it could also accelerate the development and introduction of new products and techniques that conform ‘in substance’ with the macro-concepts of Islamic finance and contribute to the socio-economic development of Muslim countries.

**Works Cited**


**NOTES**

1. A very extensive report on the causes of the financial and economic crisis in the United States was presented to the US president and Congress and published in early 2011 by the Financial Crisis Inquiry Commission (2011). Issues of ethics in finance have been dealt with before the recent crisis, but have gained more public and academic attention; see, for example, Boatright (1999, 2008), Van Liedekerke, Van Gerwen and Cassimon (2000), Boatright (2010).

2. A representative collection of contributions from well-known Islamic economists was published by the Islamic Economic Research Center, King Abdulaziz University; see Group of Researchers (2010); further examples are Mirakhor and Krichene (2009) and Amin (2009).

3. For a recent elaborate treatise on the stability issue see Askari, Iqbal, Krichene and Mirakhor (2010).

4. The findings of this study are to some degree contradicting the results of an earlier IMF working paper: Čihák and Hesse (2008). Both papers suffer from weaknesses in their data bases.

5. For a survey of the effects of the crisis on Islamic financial institutions in the Gulf region see Standard & Poor’s (2009).


7. 15 defaults were recorded in 2009 and 6 up to September 2010. 12 of these cases happened in Malaysia, 4 in Pakistan, 4 in the GCC and 1 in the US.
8. The first textbook on restructuring techniques is Abdullah and Ramli (2011); for a regulatory perspective see IFSB and World Bank (2011).

9. A considerable number of textbooks on the theory and practice of Islamic finance have been published in the last few years; see, for example, Karim (2008), Yatim and Nasir (2008), Schoon (2009), Ismail (2010), Saat, Ramli and Aminuddin (2011).


11. See, for example, Nienhaus (1983), Farooq (2007).

12. The bank either sells the commodity from its own inventory or buys it at the actual market price from a third party before entering into the contract with the client.

13. The use of such contracts for transactions with non-banks does not meet the recommendations of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Organization of the Islamic Conferences (OIC) Fiqh Academy – see Khan (2009) –, but Islamic banks apply them anyway for a wide range of products.

14. A hotly debated instrument based on an elaborate wa’d structure – the ‘total return swap’ – has been outlined in a paper produced by Deutsche Bank (2007). The Shari’ah related issues of wa’d were expounded at length by a team of prominent Shari’ah scholars. A fundamental critique of the ‘total return swap’ was articulated by DeLorenzo (2007-08); another critical assessment is given by Laldin (2009).


16. More information can be found on IIFM’s website: www.iifm.net, although a fee is charged for the download of relevant documents; see also Barwise, Rascoe and York (2010) and Parker (2010, 2010a).

17. For more details on sukuk, see Jobst, Kunzel, Mills and Sy (2008), Kettell (2009), Securities Commission Malaysia (2009).

18. Whether the asset or only the usufruct has been transferred also makes a difference for the rating of sukuk by rating agencies; see Hassoune, Damak and Nassif (2007), Leong (2008).

19. The most influential critique was raised by the chairman of the Shari’ah board of AAOIFI, Muhammad Taqi Usmani (2007); for a summary of the critique and the reactions see Yean (2009).

20. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) are the two most important supranational standard setters for Islamic finance. Their standards, however, are not binding but serve as recommendations for national authorities.

21. These expectations are determined predominantly by the market rate of interest for (risk free) conventional savings and term deposits.

22. In a (probably not representative, but nevertheless not irrelevant) survey of 22 Islamic financial institutions (IFIs), Hawkamah found that “14 IFIs (63.4%) recognize the IAHS [investment account holders] right to monitor the performance of their investment and the associated risks and 13 IFIs (59.1%) inform ex ante IAH of the risk profile of the institution, investment strategy and associated risks. Only 54.6% of IFIs make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage” (Hawkamah Task Force 2010, 23).
23. Exceptions are the financial systems of Iran and Sudan where the Islamic sector is dominant.
24. See, for example, El-Gamal (2006) with further references.
25. This was also the ambition of the initiators of the first Islamic bank in Egypt in the 1960s, but it was in fact terminated in the early 1970s.
27. See Abbas (2008) for some speculations about the income of Shari’ah scholars.
31. The recommendations in Hawkamah’s Draft Policy Brief are mostly based on and very similar to IFSB recommendations.
32. Governance Standard No. 5 on “Independence of Shari’a Supervisory Board”, Appendix A.
33. Guiding Principles on Shari’ah Governance Systems, paragraph 45. The IFIs “should decide if a member of the Shari’ah board is able to and has been adequately carrying out his or her duties in serving his or her Shari’ah board. Internal guidelines should be adopted that address the competing time commitments that are faced when members of the Shari’ah board serve on multiple Shari’ah boards.” Hawkamah found in its survey of 22 banks: “In the respect of mitigating conflict of interest in the event the Shari’a board member sitting in numerous SSB [Shari’ah Supervisory Boards], only 23.58% of IFIs impose restriction on multiple appointment, 52.4% require disclosure on Shari’a board member’s information and also demand declaration in writing” (Hawkama Task Force 2010, 25).
34. Guiding Principles on Shari’ah Governance Systems, paragraph 17.
36. Islamic financial institutions of a specific country include mainly top scholars from the same country; see the country data for Kuwait, UAE, Saudi Arabia, Bahrain and Qatar in Ünal (2011, 16-20).
38. The estimated global size of the Islamic financial services industry is 1.13 trillion US$; see Dar and Azami (2011, 34).
39. Many ethical and Islamic institutions add weapons and tobacco to their negative lists.
40. For the time being, only very few (if any) listed companies could be found whose business is totally free of any interest element. Companies usually have some interest-bearing liabilities (because of debt financing), and many also have interest income from bank balances. To exclude all such companies from the universe of permissible stocks might leave Islamic financial institutions with a nearly empty investment space. To avoid this radical consequence (which would pose a serious threat to the Islamic finance industry), Shari’ah scholars have allowed investments in stocks with some degree of ‘interest pollution’. The income from such stocks should be purified, i.e. the percentage of dividends that originates from interest must be donated for social purposes.
41. Providers of Islamic stock indices such as Dow Jones of FTSE screen all stocks and have come up with a kind of catalogue of Shari’ah compliant equities. Although they use basically the same technique, the particulars of the pragmatic settings – such as the exact definition of the relevant financial ratios or the threshold levels – differ. For example, Dow Jones Islamic Index requires that all of the following ratios must be less than 33%: total debt divided by trailing 12-month average market capitalisation, the sum of company’s cash and interest bearing securities divided by trailing 12-month average market capitalisation, account receivables divided by trailing 12-month average market capitalisation. FTSE Islamic Index requires the following ratios: debt divided by total assets < 33%, cash and interest bearing items < 33%, account receivables and cash <50%, non-compliant income other than interest < 5%, total interest income < 5%, purification ratio 5% of dividends (Securities Commission Malaysia 2009a, 21); see also Mian (2008).

42. For example, the Shari’ah Advisory Council of the Securities Commission Malaysia has classified 89% of all securities on the Malaysian stock exchange as Shari’ah compliant (as of 20 May 2011); see Securities Commission Malaysia (2011, 19). The screening methodology is also summarized in this publication, but for a detailed explanation and comparison with Dow Jones and FTSE see Securities Commission (2009a, 13-26).

43. See also Van Liedekerke and Jaufeerally (2010).

44. This can be seen by a glance at the subjects and speakers of Islamic finance conferences in the last few years. A large number of programme flyers and calls for papers can be found on the internet.

45. For example, the Securities Commission Malaysia (SC) points out in the recently published Capital Market Masterplan 2 – which gives the orientation for the Malaysian capital market development until 2020 – that “the SC will promote a shift from a Shariah-compliant approach to a Shariah-based approach where the underlying structures of products such as mudharabah and musharakah would originate from risk-sharing principles and offer significantly different pricing and returns characteristics. There is a need therefore to focus on product innovation and development efforts that will provide a comprehensive array of Shariah-based products for the industry. Towards this end, there will be further development of the Shariah legal, regulatory and governance framework” (Securities Commission Malaysia 2011a, 48).


47. IBF NET is an e-mail based forum at yahoo: http://finance.groups.yahoo.com/group/ibfnet/ [accessed August 17, 2011].

48. See, for example, my own contributions in Quantum and Islamic Finance News: Nienhaus (2011, 2011a).