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I. INTRODUCTION

In common parlance, risk equates to uncertainty. Regardless of whether the origin of the word is the Arabic *rizq* (meaning provision allotted by the Almighty), as suggested by some scholars, or derived from the Italian *risiccare*, to dare, the word “risk” points to an element of uncertainty in the future and especially to the possibility of a variety of outcomes to the decisions that people make for themselves and others.¹

Shari'ah compliance risk is the possibility that a financial service or product is not or will not be in compliance with established Shari'ah principles and standards. Financial products and services designed especially for the Islamic financial marketplace are distinguished from their conventional counterparts by their compliance with Shari'ah precepts and principles. While these products and services may appear similar to conventional financial products and services, particularly from an economic perspective, the contractual and structural underpinnings of these products and services comply with the Shari'ah.² Thus,

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Shaykh Yusuf is the author of *A Compendium of Legal Opinions on the Operations of Islamic Banks* (Inst of Islamic Banking & Ins 1996), the first English/Arabic reference on the legal rulings issued by Shari'ah boards. He has also written numerous articles, research papers, and chapters in books on Islamic finance, including translations of works from Arabic, Persian and Urdu. Shaykh Yusuf was recently appointed Chief Shariah Officer at Shariah Capital Inc, a US company traded publicly on the London AIM Exchange.


² David E. Upton, *Foreword*, in Stella Cox, Bryan Kraty, and Abdulkader Thomas, eds, *Structuring Islamic Finance Transactions* xi, xv-xvi (Euromoney 2005). Furthermore, an identity of financial implications should not be considered as a lack of philosophical differences. An example close to
while a Shari‘ah-compliant home finance contract may resemble a conventional mortgage in many ways, the underlying structure is quite different. Simply stated, while the economics are the same, the mechanics are different.

Shari‘ah compliance is what lends a financial product or service its legitimacy in the Islamic marketplace. Ultimately, Muslim consumers, investors, and clients are concerned with compliance because the religion restricts consumption to that which is good and wholesome (“halal ‘un tayyib”) while prohibiting what is foul, harmful, unjust, or sinful. A *fatwa* immediately relieves the ordinary consumer of the burden of having to make that determination for himself. It is from this perspective that the Shari‘ah supervisory board (“SSB”) may be viewed as both an auditor (for the company offering the financial service or product) and a consumer advocate (for the company’s clients).

In the hierarchy of risks established for modern financial institutions, Shari‘ah compliance risk may be considered a form of operational and regulatory risk. Certainly though, Shari‘ah compliance assumes that a financial product or service is already compliant with conventional financial standards and regulations. Shari‘ah compliance should never be understood to mean that a financial product or service falls outside the norms established for its conventional market equivalent; certainly not in terms of regulation. In any case, Shari‘ah risk is actually an umbrella risk category beneath which there may be several subcategories; its management effectively enhances industry best practices and compliance with jurisdictional standards and regulations.

At a time when interest in Islamic finance is growing, it is important to understand how Shari‘ah-based considerations may impact a business or a transaction, as well as measuring, classifying, and quantifying the sorts of risks associated with Shari‘ah compliance. Clearly, being able to identify and to understand Shari‘ah compliance risk is an important key to providing a consistent framework for managing that risk. Emphasizing this importance is the relatively recent emergence of Islamic finance and its continuing efforts to develop industry standards and best practices. Indeed, as this Article will explain, there is much that remains to be accomplished by the industry internally.

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3 For an explanation of the three widely used contracts for home finance, see Virginia Morris and Abdulkader Thomas, *Guide to Understanding Islamic Home Finance in Accordance with the Islamic Shari‘ah* (Lightbulb 2002).

4 *A fatwa* is a formal response to a question by an Islamic legal authority. In modern Islamic finance, a *fatwa* is a formal certification of a financial product or service by a qualified Shari‘ah expert, or a group of such experts (also called a Shari‘ah supervisory board).
Shari‘ah compliance risk may be classified in terms of the levels of that risk, the factors that constitute it, and its strategic and tactical management. Management of Shari‘ah compliance risk, like other forms of risk management, may also be seen as having a lifecycle. The purpose of this Article is to explore this subject in a preliminary manner, to lay the foundations for its definition, to describe its characteristics and implications, and to examine how it is presently managed by Islamic financial institutions. It is the author’s hope that this Article will contribute to an understanding of the subject and lead to more systematic studies of this area in the future.

II. MANAGING RISK

A risk is a degree of uncertainty. The most important step in managing risk is the ability to identify and to classify it correctly and appropriately. From that point forward, the risk can be managed, and if the risk becomes a problem, a process of resolution can begin. In the modern Islamic finance industry, the single most important factor in the management of risk is the SSB. These boards generally consist of three or more Shari‘ah scholars with specialized qualifications in finance and/or economics. They convene for the purpose of ensuring that financial products and services offered to consumers and investors are compliant with the rules and principles of the Shari‘ah. SSBs often participate in product research and development and will formally certify compliance by means of a fatwa.

Modern businesses, especially those in the finance industry, employ multiple strategies to manage risk through identification, categorization, and mitigation. These strategies may also assist in the establishment of benchmarks or thresholds with which to assess and measure risk and thus the strategies take appropriate actions to manage it. Notwithstanding disparities in the size and sophistication of business activities, the way risk is defined and the language used to do so are essential elements in the management of risk.

III. ELEMENTS OF SHARI‘AH COMPLIANCE: SHARI‘AH SUPERVISORY BOARDS

Present day perceptions of Muslim consumers and investors are such that in order for a financial product or service to be accepted as Shari‘ah compliant, it must first have the approval of a religious authority.5 In some jurisdictions, regulators now require both an SSB and a fatwa for any company offering Islamic financial services and products. It is now universally accepted that

without formal approval through certification by means of a fatwa, no issuer or product provider will be able to market the financial service or product successfully to the Islamic financial community. Certification, therefore, signifies to the Muslim client that a product complies not only with jurisdictional regulations, but that it has also been subjected to scrutiny by an authority on Islamic transactional law and is therefore consistent with Shari’ah rules and standards.

For the successful management of Shari‘ah compliance risk, SSBs must work closely with management and its internal or external counsel throughout the process of product development. In regard to a completely Shari‘ah-compliant company, the SSB will work on every relevant facet of its business operations, including its capital structure and nature of business. Typically, SSBs assist in the pre-certification stages, such as product development and structuring, or in the early stages of operations. Then, the SSB will issue a fatwa to certify the finished product, process, or service. In the case of a Shari‘ah-compliant offering, this will take place before an Offering Memorandum or Prospectus is issued or before a product is introduced to the market. By this stage, the SSB should have worked with management to identify and to mitigate all possible Shari‘ah compliance risks. Thereafter, the SSB will continue to assist in the risk management of the product or service.

Throughout the product lifecycle, it is the responsibility of the SSB to work with management to ensure that everything about the financial product or service is in compliance with the principles and precepts of the Shari‘ah and, equally as important, to ensure that there is sufficient transparency in the Shari‘ah process so that the product or service is understood by consumers or investors to be Shari‘ah-compliant. Indeed, the Shari‘ah process can be complex and demanding and requires significant attention from product producers and investment managers. Business, legal, and Shari‘ah teams should work together on projects from the earliest stages to ensure that there are no “false starts” so the work may proceed smoothly toward a well-identified goal. Such a process, however, requires dedicated management. All too often, products and processes are developed without the participation of SSBs, such that proposals are submitted to SSBs for review, approval, and certification only weeks or days before a target date for launch. Obviously, truncation of this sort can only spell difficulty for the product development lifecycle.

However, neither the presence of a fatwa nor an SSB is sufficient to guarantee complete market acceptance for the Shari‘ah compliance of a financial product or service. Indeed, there is risk associated even with the fatwa and with the SSB itself. Fatwa risk, as will be discussed in more detail below, has to do with the possibility that the fatwa is ambiguous and will not be understood, that the fatwa is not sufficiently detailed, or that it is overly concerned with detail and thus indecipherable to all but those with specialized knowledge. Likewise, there
is also a risk that an SSB will not be accepted as a qualified authority for giving an opinion on a particular financial product or service. The adage that there are no guarantees in life is certainly applicable to Islamic finance. However, if management begins by understanding that there are risks associated with Shari‘ah compliance and then works closely with its SSB to manage those risks, the path forward will almost always be a smooth one.

Islamic financial institutions found it necessary to consult with specialized Shari‘ah scholars in order to deal with Shari‘ah compliance risk. From the early days of the modern revival of Islamic finance, financial institutions discovered that the best way to deal with the risk of non-compliance with Shari‘ah norms was by bringing in experts on the Shari‘ah rules for transactions to study their operations, instruments, procedures, and structures. Very soon it was discovered that the opinions of several scholars, covering a wider range of jurisprudential thinking, were more likely to receive a positive reception from the bank’s clientele. Soon after, the practice of consulting SSBs became widespread. In the late 1990s, the Accounting & Auditing Organization of Islamic Financial Institutions (“AAOIFI”) promulgated a standard, mandating that all member institutions maintain SSBs.

Institutions with operations at a local or regional level will generally require an SSB with local or regional membership only. However, once an institution seeks to do business across borders, the risk that its Shari‘ah board members will not be recognized outside of their home countries is greater. In order to manage this risk, institutions doing business globally—whether banks, asset managers, finance companies, or index providers—have established SSBs with scholars of international repute whose backgrounds cover a broader cultural and linguistic constituency. Indeed, the membership of such multinational SSBs will represent not only the major schools of jurisprudence, but the chief geographical regions in the Muslim world as well.

Factors that influence the selection of scholars for an SSB generally include their: (1) public reputations as academics; (2) relevant honors and titles; (3) advisory roles with public institutions; (4) publications (especially on the subject of Islamic finance); (5) membership on the Shari‘ah boards of reputable international financial institutions; (6) their academic backgrounds and other fundamental qualifications like facility in both the English and Arabic languages.

6 In many cases, the investor/client will have its own Shari‘ah supervisory board, or Shari‘ah advisor. It is possible that the investor SSB will reject the fatwa issued by the product developer. This Article will discuss possible reasons for such rejection.

7 In 1998, the AAOIFI promulgated a standard, Auditing Standard for Islamic Financial Institutions (“ASIFI”), regarding the definition, appointment, composition, and reports of SSBs. This has now been adopted by financial regulators in several Middle Eastern and, in particular, Saudi Arabia and the Gulf Cooperation Council (“GCC”) countries.
and appreciation for the broader social and economic contexts of Islamic Finance; and (7) availability. In recent years, as demand for such scholars has continued to grow, this particular consideration has taken on added significance. In businesses that require quick decisions—securities trading, private equity, and the like—the issue of accessibility can be crucial.

IV. ELEMENTS OF SHARI’AH COMPLIANCE: THE FATWA

It is widely assumed that a fatwa is all that is required to open the doors to Islamic financial markets all over the world. The reality of the matter is a little different. While the risk of market rejection is certainly mitigated by the issuance of a fatwa, it is not a guarantee for success. Commercial practice among modern Islamic financial institutions dictates that a fatwa precede or accompany the marketing and release of products, and the fatwa has become a condition precedent for most, if not all, Shari’ah-compliant investments. At the same time, however, even though a fatwa is directed toward a variety of stakeholders, there is always a risk that a fatwa will not satisfy everyone, and that, in spite of Shari’ah-board certification, people will reject the SSB’s finding that the product offered is compliant with Shari’ah rules. Obviously, when this happens at the consumer or investor level, there is a serious problem.

A. FATWA RISK: REJECTION

In order to be prepared to mitigate the risk of fatwa rejection, it is necessary to understand why such rejection is possible. Though rare, there are many reasons consumers reject a fatwa. Possible reasons for such rejection may include: (1) differences of legal philosophy in cases where a Shari’ah board bases its fatwa on the opinion of a minority legal school or an obscure jurist in a minority legal school; (2) lack of disclosure resulting from a fatwa that fails to include the level of detail required by investors and their Shari’ah boards; (3) failure of an investor Shari’ah board to comprehend the operations or structures described in a fatwa issued by the SSB of an investment product, either because the fatwa fails to explain them appropriately or because the investor Shari’ah board is simply unfamiliar with the concepts involved and elects to be prudent by rejecting the fatwa; and (4) rejection by consumers who feel that a fatwa has not adequately addressed their concerns regarding religious compliance. In practical terms, if these risks are to be managed effectively, management will have to work closely with the members of its SSB to ensure that the Shari’ah
process is carefully managed. Such management includes control of the fatwa's content, language, signatories, distribution, and preservation.

While the principles and precepts of the Shari'ah on the subject of finance are widely acknowledged, the industry has nonetheless labored to develop Shari'ah standards. Honesty, transparency, honoring contracts, meeting obligations, dealing fairly with others, and reward following the assumption of responsibility (for loss) are all high-level principles of transacting in compliance with the Shari'ah. They find expression in any number of texts, including the Qur'an and the Sunnah. Likewise, the prohibitions against usury and interest, profiteering, cheating, ambiguity in contracts, investing in sin industries, and the like are also well known. Even so, as texts may be interpreted differently, there is always the possibility that a fatwa may be rejected when it is found to be based on disputed legal premises. Thus, management of the entire Shari'ah process—from the development phase, which is often conceptual in nature and thus open to interpretation, to the fatwa stage and beyond—is an essential part of managing Shari'ah compliance risk. Obviously, informed management of such a process will be a positive factor in the management of Shari'ah compliance risk.

A negative finding in relation to a financial product or service may come in the form of a formal rejection by an SSB when it refuses to certify the product or service by means of a fatwa. The refusing SSB, however, may be affiliated with the product developer or manager, so that the rejection is internal and addressed outside of the public eye. On the other hand, the rejection may come from an SSB affiliated with an investor or consumer entity. In some instances, a rejection may come from an independent Shari'ah authority, like a mufi, an imam, or a community leader, sometimes in the form of a website declaration. Such rejections may lead to general rejection by the consuming public. Ultimately, the

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8 In fact, while it is not at all common at the present time, I believe that in the future an increasing number of businesses offering Shari'ah-compliant financial products and services will employ Shari'ah experts as executives for the management of their Shari'ah processes. Such executives may play a key role in ensuring the Shari'ah compliance of all operations by working alongside the SSB, by assessing the feasibility of proposals at the initial stages, and by assisting in project development and execution. Obviously, as a member of the management team, such an expert would have to recuse himself from actually signing a fatwa. Even so, like in-house legal counsel, such an executive would add immense value to the specialized nature of Shari'ah-compliant business. In this manner, the company will abide by the internationally recognized standards for Shari'ah supervision set by AAOIFI while maintaining an interested, in-house Shari'ah capability of its own.

9 See, for example, Qur'an 5:1 ("O you who believe! Honor all contracts"); Qur'an 4:29 ("Do not devour one another's possessions wrongfully—not even by way of trade based on mutual agreement"). The texts of the Sunnah, the doings and sayings of the Prophet, upon him be peace, are usually more specific; though these too may be general in nature.
risk of such rejection is that the issuer will be unable to find a ready market for its product.

If the Shari'ah process is well-managed, rejection can be prevented by anticipating the impact of a product on the target market, investor, or investor SSB. If necessary, the chair of the issuing SSB will contact either the chair of the investor SSB that will consider the fatwa or a member of the investor SSB with whom there is a relationship, and the two will attempt to come to an understanding that will satisfy both sides. In fact, the more prudent course in such situations is to arrange for such a meeting or conversation well in advance of submission to the investor SSB for its formal approval. In these instances, collegial relations between Shari'ah scholars clearly play an important role in determining a mutually agreeable solution. In some cases, it is best if such a meeting is also attended by management and legal counsel for the product developer. In this way, every aspect of the transaction may be discussed.

At times, a developer may incur considerable research and development costs for a new product, including costs directly related to Shari'ah compliance and, in order to retain first-to-market status for the business, will insist on keeping the fatwa out of the public eye for a time. Obviously, there is considerable risk in such a strategy. While the rewards for first movers may be greater, there must first be a clear understanding of how to manage the Shari'ah process. Otherwise, despite the obvious economic advantages of the product, the market may not be ready to accept it. This is especially true of more exotic and complex investment and liquidity management products.

B. JURISTIC DIFFERENCES

Among the factors potentially contributing to the risk of fatwa rejection is the matter of juristic differences among the major schools of jurisprudence. Indeed, while the classical schools agree on the great majority of issues, there are differences, even in their legal methodology, which could lead to significantly different findings. This is especially true with regard to financial products and services for which there is no precedent or clear ruling from the classical texts. Perhaps this preliminary study is not the place to discuss particulars. However, there is a growing need to address the jurisprudential differences between SSBs in the Arabian Gulf and those in Malaysia. Such a discussion should be carried out on a number of different levels, but most Shari'ah scholars

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10 For an informative modern study of this matter in the classical schools of jurisprudence, see Umar Kahhala, *Athr Ikhtila‘f al-Ussal ‘ala’l-Furu* (Dar al-Fikr 1969). As yet, no such study has been undertaken with reference to the rulings of SSBs. It is likely, however, that such a study will prove especially valuable as the industry moves forward. Beginning with case studies, concerted research may soon lead to comprehensive and systematic studies.
involved in the modern Islamic finance industry as Shari`ah board members would agree that the discussion should begin at a very high academic level so as to begin the discussion far from commercial considerations. Indeed, the government of Malaysia is to be commended for taking a positive first step in this direction when it convened an international conference of Shari`ah scholars in 2005 and then announced the establishment of the International Centre for Education in Islamic Finance, a graduate-level teaching institution.11

Certainly, one factor in such differences of opinion is the lack of precedent in the classical corpus of Islamic law, *fiqh*, for the contracts underlying many of the products, services, structures, and processes used in modern Islamic finance. While the early generations of Muslims were accomplished merchants and traders who produced volumes of legal thought on the subject of commerce and transacting, the world has changed, and the law is only now beginning to catch up. There is certainly nothing novel in this situation. As the world changes, so also does the interpretation and application of the law. For example, British and American common law notions of the classical "freedom of contract" have undergone several significant changes in the past half century alone.12 The inner dynamic of *ijtihad* is what allows Islamic law to renew itself continually and to adapt itself to changing circumstances. Derived from the same Arabic triliteral root as jihad, j-h-d, the meaning of *ijtihad* is the expending of the utmost effort in the exercise of legal scholarship. While the scriptural foundations of Islamic transactional law may be abbreviated (owing to their delineation of principles rather than specifics), the dynamic of *ijtihad* inherent to *fiqh* has ensured that Muslim jurists continue to comment and to build upon the theoretical constructs.13

What the *fiqh* offers is a learned point of departure and, perhaps most importantly, a comprehensive and complex methodology for legal interpretation and application. Modern SSBs are beginning to employ a more proactive and participatory jurisprudence of innovation and transformation by reconfiguring the nominate contracts14 or, perhaps more exactly, by thinking of the nominate contracts, or *al-'uqud al-musammab*, as those contracts which found currency in the classical period of Islam and which therefore received specific mention and treatment in the classical manuals of law. With reference to contracts other than those named (non-nominate), Islamic law operates on the principle that all contracts are to be allowed as long as these are not contrary to Islamic legal precepts. See Wahba al-Zuhayli, *4 al-Fiqh al-Islami wa Adillatub* 242 (Dar al-Fikr 1989).

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14 The nominate contracts, or *al-'uqud al-musammab*, are those contracts which found currency in the classical period of Islam and which therefore received specific mention and treatment in the classical manuals of law. With reference to contracts other than those named (non-nominate), Islamic law operates on the principle that all contracts are to be allowed as long as these are not contrary to Islamic legal precepts. See Wahba al-Zuhayli, *4 al-Fiqh al-Islami wa Adillatub* 242 (Dar al-Fikr 1989).
contracts as building blocks that may be constituted and constructed creatively for the achievement of all manner of financial and contractual objectives. Modern SSBs have engineered and approved a host of hybrid nominees, using a single nominee such as *murabahah* in different configurations (such as parallel *murabahah*, reverse *murabahah*, back-to-back *murabahah*, and reverse-parallel *murabahah* contracts), or by using a plurality of nominee contracts in combination with one another. In this manner, the nominee mainstays of classical Islamic commercial law, *musharakah*, *ijarah*, *salam*, *istisna’*, *mudarabah*, and others have been transformed and adapted in a variety of ways to modern needs and circumstances. An example is the adaptation of these contracts to bring about interest-free alternatives to conventional mortgages for the financing of homes. In other cases, these derivatives became key elements in investment funds, project finance, and, most recently, in Islamic debt instruments like *sukuk*.

Likewise, contracts described in the classical *fiqh* formed the basis for sophisticated trade practices throughout the Indian Ocean region for centuries, including, for example, an advance finance contract system that was adapted by the Europeans as a “putting-out” model when they arrived to trade in the region. What modern Shari’ah boards may derive from such a model, based on the *salam* sale nominee, is a point of departure for the consideration of such modern ways of contracting as deferred sales, futures, and options.

To a significant degree, the efforts of the AAOIFI and the Islamic Financial Services Board have helped to bring about and to publicize standards for the industry, including Shari’ah standards. Such standards, however well-formulated, sometimes lag behind developments in the marketplace. Consider, however, in regard to *sukuk*, how the promulgation of the Shari’ah standards for *sukuk* effectively initiated that industry. There is clearly a greater risk for structures, instruments, and transactions that are not yet covered by AAOIFI standards. If something is new to the market, it will be new to SSBs. Structured

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18 Full information regarding these two organizations may be obtained from their websites: Accounting & Auditing Organization for Islamic Financial Institutions, available online at <http://www.aaoifi.com> (visited Jan 15, 2007); and Islamic Financial Services Board, available online at <http://www.ifsb.org> (visited Jan 15, 2007).
principal protection products, for example, were first developed for the Islamic financial market following the burst of the dotcom stock market bubble in 2000–2001. At first glance, structured principal protection products appeared to contravene the Shari'ah principle of reward following responsibility for loss, as well as several others. Accordingly, many SSBs were hesitant at first to accept the structures underlying such products. Once they became more common, and SSBs had studied and grown familiar with them, general acceptance followed.

V. CONCLUSION

Philosophical differences, or what might be considered purely jurisprudential issues, will play a part in the decisions of SSBs. For example, the Shari'ah is concerned with social justice. In the marketplace, the role of the Shari'ah is prominent because the business of earning a living concerns everyone, as individuals, as groups within society, and as citizens of nations and the world. The logic of the relevant Islamic teachings is that everyone will benefit when people earn their living in a wholesome and lawful manner and social stability is supported by commercial society. Thus, at the core of Islamic finance are religious precepts governing what is good and permitted, or lawful, and what is harmful and forbidden, or unlawful. It is the responsibility of the SSB jurist to help distinguish the one from the other. As markets grow in sophistication and transactions become increasingly complex, that responsibility becomes more and more challenging. Differences of opinion are, therefore, bound to occur. Careful management of the Shari'ah process will almost certainly help prevent this risk from becoming a problem.

Risk is a part of business; without it, business cannot exist. Total aversion to risk equates to taking no chances and to making no choices, thus creating a

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19 Such products obviously differ in significant ways from the conventional capital guaranteed products that they effectively emulate from an economic perspective.

20 While examples abound, it may be instructive to cite a recent fatwa by an SSB in Saudi Arabia which gave approval to investments in a company with a network of retail clothing stores, including brands that are well known for advertisements that feature scantily clad models, sometimes in suggestive poses. The SSB gave its approval on the basis that the business of the retailer was the sale of clothing, while the advertising was done not by the retailer but by the designers. The approving SSB included at least one scholar who rejected investments in an advertising firm for the reason that it was producing advertisements that featured scantily clad models. See Islamic Scholars Sanction Trading of Alhokair IPO Shares (Oct 9, 2006), available online at <http://www.zawya.com/story.cfm/sidZAWYA20061009110125/SecIndustries/pagIslamic%20Finance/chnMiddle%20East%20Islamic%20Finance%20News/objDDA417C3-600D-11D6-86D70D74A002D/> (visited Jan 15, 2007). On the other hand, SSBs regularly reject investments in warehouses or transport companies if the majority of their revenues are derived from contracts to store or to transport alcohol.

21 DeLorenzo and McMillan, Law and Islamic Finance at 141 (cited in note 15).
state of inertia and stagnation. By facing risk and learning to manage it, people have advanced themselves and society. The same is true of Shari`ah compliance risk. If it is intelligently and appropriately managed, Shari`ah-compliant finance will thrive and advance.