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White Paper:

**TAKING STOCK AND MOVING FORWARD:
THE STATE OF ISLAMIC FINANCE AND PROSPECTS
FOR THE FUTURE**

DIFC, May 4, 2010



KING & SPALDING

Foreword

On May 4, 2010, the American Bar Association, Section of International Law, Islamic Finance Committee (IFCO) and Hawkamah, the Institute for Corporate Governance at the Dubai International Financial Centre (DIFC) jointly hosted a program, **Taking Stock and Moving Forward: The State of Islamic Finance and Prospects for the Future**. The Program was intended to facilitate discussion of the lessons derived from the experience of Islamic Finance in recent years and to envision the path forward from the vantage points of Shari'ah scholars, standard-setters, regulators, bankers, lawyers, compliance professionals, and industry observers. We are pleased to have achieved our goals.

The discussion of the key questions raised and discussed on May 4, 2010 continues, initially in the form of this White Paper, a compilation of the thoughts of Program participants.

We are grateful to our sponsors, the law firm of King & Spalding and business information provider Zawya, the DIFC, and our Program speakers, and attendees for their participation and support. For more information about the May 4, 2010, program, please visit http://www.hawkamah.org/news_and_publications/news/2010/73.html.

We are hopeful that the Program and this White Paper will prove valuable contributions to the ongoing discussion about Islamic Finance, and we encourage and welcome your feedback in this regard.

With thanks and regards,

Hdeel Abdelhady

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ABA Islamic Finance Committee



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The Front Office Generates Revenue, the Back Office Creates Value: Operational Excellence is the Key to Unlocking Lasting Value in Islamic Finance

By Hdeef Abdelhady¹

*It is not righteousness that ye turn your faces towards East or West;
But it is righteousness to believe in Allah and the Last Day,
and the Angels, and the Book, and the Messengers;
To spend of your substance, out of love for Him, for your kin, for orphans,
for the needy, for the wayfarer, for those who ask, and for the ransom of slaves;
To be steadfast in prayer, and practice regular charity,
to fulfill the contracts which ye have made;
And to be firm and patient, in pain (or suffering) and adversity,
and throughout all periods of panic.
Such are the people of truth, the God-fearing.*

-THE NOBLE QUR'AN, 2:177

The quoted Qur'anic aya (verse) crystallizes a fundamental Islamic value: form does not trump substance, and outward adherence to religious injunctions does not, without more, equal piety.² Rather, piety is measured by deeds motivated by sincere faith, perceptible or imperceptible to others. The significance of this verse for individual Muslims is clear. And it applies to institutions that hold themselves out to the public as "Islamic", whether in the form of Islamic banks, Islamic windows of conventional banks, or other providers of Islamic financial products and services, such as takaful and financial advisory. Islamic Financial Institutions (IFIs) must ensure that behind the scenes, in their back offices, their operations are of a quality that ensures that representations about the nature of their business model, products, services, and commercial and legal objectives are true to the religion-derived principles to which they owe their market share. This requires operational excellence in the back offices of IFIs, which must be facilitated and reinforced at the industry level. Operational excellence is the key to unlocking lasting value in Islamic Finance.

This note discusses two published court opinions involving IFIs—*The Investment Dar v. Blom* ("Blom") and *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd.* ("Shamil") — and IFLI Shari'ah Board Reports and

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² This aya (verse) appears in *Surat Al Baqara*, Chapter Two of the Holy Qur'an. *Surat Al Baqara*, comprised of 286 ayat (verses), is the longest Chapter in the Qur'an and is said to sum up "the whole teaching of the Qur'an." Abdulla Yusuf Ali, *THE MEANING OF THE HOLY QUR'AN* (Amana Publications, 11th ed. 1425AH/2004AC) at page 16.

their implications for governance and brand management.³ In this note, the notions of operational quality and governance are broad, and are used interchangeably.

1. The Need for Operational Excellence in Islamic Finance is Particularly Compelling

The financial crisis and other well-known governance failures (recall Enron) are powerful reminders of a universal truth: Rules, whatever their source, are only as good as their enforcement. Laws alone are insufficient to prevent practices motivated by short-term gain, to the detriment of long-term value. This is particularly true for Islamic Finance, which operates globally without comprehensive industry-specific regulation, making external regulatory checks on governance moderate to non-existent. Further, the nature of the relationship between IFIs and consumers of their products and services, based on the Islamic profit and loss sharing construct (PLS), requires that IFIs be operationally strong, to maximize returns for consumers and shareholders.⁴ Most obviously, IFIs, owing their existence to a religion-based ethical model, must be, and convincingly appear to be, ethical. Vigilant self-governance is required to preserve the Islamic brand, maximize profitability, and fill legal and regulatory gaps.⁵

2. Governance Shortfalls Revealed: Case Studies

In the last paragraph of the well-known February 2008 AAOIFI clarification on sukuk, AAOIFI's Shari'ah Board advised IFIs "to decrease their involvement in debt-related operations and to increase true partnerships based on profit and loss sharing in order to achieve the objectives of the Shari'ah."⁶ The advice, seemingly a postscript to AAOIFI's sukuk clarifications, is broad in scope and applicability, and has ramifications for governance at the institutional and industry levels. Published court opinions and Shari'ah Board Reports (SBRs) issued by IFIs shed light on areas in which improvements to operational quality should be made. While court opinions and

³ *The Investment Dar Company KSCC v. Blom Development Bank SAL*, 2009 EWHC 3545 (Ch), available at, [http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWHC/Ch/2009/3545.html&query=title+\(+blom+\)&method=boolean](http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWHC/Ch/2009/3545.html&query=title+(+blom+)&method=boolean) (last accessed October 2010); *Shamil Bank of Bahrain EC v. Beevicco Pharmaceuticals Ltd.*, 4 All E.R. 1072 (2004), available at, [http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWCA/Ch/2004/15.html&query=title+\(+shamil+\)&method=boolean](http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWCA/Ch/2004/15.html&query=title+(+shamil+)&method=boolean) (last accessed October 2010).

⁴ Consumers of Islamic financial products are more akin to equity investors, partners, and co-venturers than they are to consumers of conventional debt-based products. In assessing equity-based investments and ventures, the soundness of management and operations figures prominently. The quality of the management and operations of IFIs should figure equally prominently in the assessment of Islamic products.

⁵ A recent survey of Islamic Finance leaders in the Middle East revealed that 66% of survey respondents believed that the Islamic Finance industry is "under-regulated." See *The Deloitte Islamic Finance leaders survey in the Middle East, Benchmarking practices*, Biannual Survey Issue 1, at page 13, available at, http://www.deloitte.com/assets/Docu-Lebanon/Local/20Assets/Documents/FSI/DTME_IFLS_publication_23092010.pdf (last accessed October 2010) (hereinafter the "Deloitte Survey").

⁶ *Resolution on Sukuk*, ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS, February 2008, available at, http://www.aaofi.com/aaofi_sb_sukuk_Feb2008_Eng.pdf (last accessed October 2010).

SBRs are, by their nature, specific to institutions and situations, they have industry-wide ramifications and their lessons should be heeded broadly.⁷

The Blom Case

In *Blom*, The Investment Dar ("TID"), an IFI, asserted its own failure to comply with Shari'ah as a defense to an apparently valid demand for payment by Blom Development Bank ("BDB"). TID's Memorandum of Association prohibited its engagement in "any usury or non-Shari'ah compliant activities."⁸ In October 2007, TID and BDB entered into a wakala agreement, pursuant to which BDB deposited USD 10 million with TID as its agent, for Shari'ah-compliant investment in TID's "treasury pool."⁹ The TID-BDB transaction and the form of master wakala agreement were previously approved by TID's Shari'ah Board.¹⁰ TID failed in its payment obligations and BDB filed suit in English court (pursuant to English forum and governing law clauses). After an initial hearing, BDB won summary judgment for USD 10 million, the principal amount deposited. TID sought permission to appeal the summary judgment, arguing, *inter alia*, that a full trial was required to determine whether the wakala was enforceable. According to TID, the wakala was interest-bearing, not Shari'ah-compliant, and therefore unenforceable because TID did not have the legal capacity to enter into the wakala.¹¹ Subsequently, TID's Shari'ah Board issued a statement asserting that the transaction was Shari'ah-compliant, and advised TID to abandon its lawsuit with BDB.¹²

*The Shamil Case*¹³

The appellate court decision in *Shamil* was issued six years ago, but the case remains relevant. The *Shamil* dispute arose out of two murabaha and related agreements between Shamil Bank of Bahrain and Beximco Pharmaceuticals, its corporate affiliates and directors (collectively "Beximco"). Beximco defaulted on its

⁷ Indeed, only 59% of respondents to the Deloitte Survey stated that the entities they represented had in place "corporate governance/procedures", while 39% did not. At the same time, 58% percent of survey respondents "viewed corporate governance and Shari'ah's governance as prerequisites for best practices." See Deloitte Survey, *supra* note 5, at page 12.

⁸ *Blom* at para. 14.

⁹ *Blom* at para. 3.

¹⁰ *Blom* at paras. 16, 17.

¹¹ *Blom* at para. 16.

¹² See *Investment Dar Gets Sharia Board Blow to Blom Case*, arabianbusiness.com, June 9, 2010, available at, <http://www.arabianbusiness.com/investment-dar-gets-shari-ah-board-blow-blom-case-282707.html> (last accessed October 2010).

¹³ A more detailed discussion of the *Shamil* case is at Hdeel Abdelhady, *Islamic Law in Secular Courts (Again): Teachable Moments From the Journey*, ABA INTERNATIONAL LAW NEWS VOL. 38, NO. 4 (FALL 2009), reprinted at OPALESQUE ISLAMIC FINANCE INTELLIGENCE DECEMBER 2009, available at, http://www.opalesque.com/OIF137/Industry_Snapshot_Islamic_Law_in_Secular_Teachable197.html (last accessed October 2010).

obligations, and Shamil Bank brought a claim in English court, pursuant to English governing law and forum selection clauses. Shamil Bank prevailed at trial and on appeal.²⁴

The disputed transactions were certified by Shamil Bank's Shari'ah Board prior to the litigation. Nevertheless, at trial, Beximco argued that the murabahas and related agreements with Shamil Bank were interest-bearing loans with Islamic names. The English court appeared to accept this characterization, stating that: "if the Shari'ah law proviso were sufficient to incorporate the principles of Shari'ah law into the parties' agreements, the defendants would have been likely to succeed."²⁵ Due to a governing law clause that did not effectively incorporate Shari'ah as a source of governing principles, it cannot be known whether the court's prediction of a favorable outcome for Beximco would have materialized, had Shari'ah applied.

3. Addressing Governance Shortfalls at the Institutional Level

Instruments Susceptible to Shari'ah Challenge

- *Innovation in Islamic Finance: Back to Basics*, TID and Shamil involve agreements that were characterized by litigants as effectively interest-bearing, and repugnant to Shari'ah. These characterizations, accurate or not, raise a frequently asked question about whether Islamic Finance has innovated sufficiently to meet consumer demand, develop and expand its market share, and bolster Shari'ah compliance. Much has been written on the subject of innovation, and the way forward would best be paved by Shari'ah experts, business professionals, and economists. For the purposes of this note, it is sufficient to state that IFIs and the Islamic Finance industry should revisit the issue of whether the "bank" operating model assumed by many IFIs is congruent with the Islamic PLS model. Owing to real commercial pressures, IFIs frequently use off-the-rack instruments (e.g., murabaha, wakala, tawarruq) that have been susceptible to Shari'ah challenges because, as implemented, they most directly compete with the term loans, fixed return investment instruments, and treasury products used by their conventional counterparts. IFIs are, after all, for-profit entities, and their responses to real commercial pressures are understandable. However, it is reasonable to question whether the continued reliance on products that are readily susceptible to accusations of Shari'ah violations and innovation shortcomings are in the best long-term interest of IFIs and the industry. More important, the wide use of such instruments, to the exclusion of innovative Islamic PLS-based offerings, denies the industry the opportunity to know and capitalize on its true potential market share, as many consumers will avoid products that appear to be Islamic in name only.
- *Ensuring Shari'ah Compliance, From Cradle to Grave*, The TID and Shamil cases both involved claims that "Islamic" agreements were effectively interest-bearing. Such accusations, if made frequently and publically, undoubtedly will have damaging effects for specific IFIs and the industry at large. IFIs must ensure that their instruments and transactions are structured, documented, and executed in a manner that minimizes the risk of Shari'ah challenges. This means that the letter and spirit of fatawa, forms of agreements, and transaction structures reviewed and approved by Shari'ah Boards must not be altered over the course of their lifetime, unless re-submitted and re-reviewed for Shari'ah compliance. Coordination and vigilance across operational units (e.g., management, compliance and legal, risk management, and

²⁴ The trial court opinion is *Shamil Bank of Bahrain v. Beximco Pharmaceuticals Ltd.*, 2 All E.R. (Comm) 849 (2003) (herein "Shamil I").

²⁵ *Shamil* at para. 55.

transaction teams) is essential to ensure that the Shari'ah character of instruments remains intact after Shari'ah Board approval.

Managing Litigation and Derivative Commercial Risk

- Legal Risk Management Should Reflect Sound Governance.*** Legal risk is as much a part of doing business as commercial risk, and legal risk management is part and parcel of corporate governance. IFIs (like other entities) must conduct their affairs in a manner that demonstrates an appreciation of legal risk, before legal disputes arise. As a matter of policy, legal risk and litigation management protocols should be written, periodically reviewed (internally and with outside counsel), and explained and disseminated to IFI personnel at regular intervals. Well-crafted protocols should address, among other issues: (1) internal approvals and considerations necessary in deciding to proceed with litigation (e.g., based on the nature of disputes, amount in controversy, likelihood of publicity, etc.); (2) forum type (e.g., arbitration, mediation, national courts); (3) jurisdiction (considering, e.g., quality of courts, typical duration of litigation, expense, and ability to adjudicate substantive issues); (4) governing law; (5) likelihood and extent of commercial risk attendant to litigation strategy; (6) internal document retention and record-keeping procedures; (7) and, the ability to produce evidence.²⁶ Legal risk and litigation management protocols should facilitate informed decisions about litigation, including whether the potential benefits of a legal strategy are outweighed by any attendant commercial risks.
- Sound Legal Risk Management Requires Coordination Across Back Office Functions.*** The *Blom* case presents a striking example of the harm that can result from a lack of coordination in making litigation decisions. The assertion in court of Shari'ah-non-compliance by an IFI whose constitutional documents prohibit its engagement in Shari'ah-non-compliant transactions is striking, to say the least.²⁷ Where Shari'ah compliance is potentially subject to dispute, the IFI's Shari'ah Board should be asked to review, with the assistance of legal counsel and relevant departments, germane documentation and transaction history and assess Shari'ah merits, before any litigation strategy is pursued. The wisdom of this approach is borne out by the TID Shari'ah Board's untimely advice that TID abandon its legal dispute with BOB.
- Evidentiary Inadequacy of Post Hoc, Wholesale Certification of Islamic Transactions.*** In the *Shamil* case, Shamil Bank submitted year-end Shari'ah Board Reports (SBRs) as proof that the disputed transactions with Beximco had been "certified" by its Shari'ah Board. The certifications were not specific to the Shamil Bank-Beximco transactions. They stated: "The Board believes that all the bank's business throughout the said year, including investment activities and banking services, were in full compliance with Glorious Islamic Shari'ah."²⁸ The evidentiary value of the certifications was not scrutinized because Shari'ah principles were not applied to decide the case. As a general matter, IFIs should be aware that such post hoc, sweeping certifications (in SBRs or otherwise), without more, might not be sufficient proof of Shari'ah-compliance or adequacy of Shari'ah oversight in litigation or in other contexts. With this in mind, IFIs should

²⁶ Where agreements call for litigation before national courts, as in the *Blom* and *Shamil* cases, the likelihood of a published opinion (particularly at the appellate stage) is high. On the other hand, if parties have opted for arbitration, the likelihood of a published opinion is slim to none, depending on the terms of arbitration, e.g., the forum selected, procedural rules, and confidentiality provisions, etc.

²⁷ Note also that TID had a Shari'ah-based obligation to fulfill the contract that it made. See, e.g., Qur'anic verse 2:177 from *Surat al-Baqara* quoted above.

²⁸ *Shamil* at para. 8.

consider whether internal records of *Shari'ah* approval, review, and compliance are of a type and quality that would evidence *Shari'ah* compliance in litigation or other contexts. A good record-keeping and retention policy should address such issues.

- Governing Law and Forum Selection Should Demonstrate Commitment to Shari'ah Compliance.* Many parties to Islamic Finance contracts select secular (e.g., English) law and courts in their governing law and forum selection clauses, for good reason. English and other jurisdictions outside of Islamic Finance hub jurisdictions provide the transparency and predictability necessary for effective dispute resolution. At the same time, as was the case in *Shamil*, secular courts will often refuse to apply *Shari'ah*, apply it in a limited fashion, or are ill-equipped to interpret *Shari'ah* if applied.²⁰ IFIs, while reasonable in choosing such jurisdictions, should draft their governing law and forum selection clauses to ensure that *Shari'ah* principles are applied to decide the substantive elements of legal disputes. The use of governing law clauses that effectively incorporate *Shari'ah* is in the interest of IFIs and the Industry generally. If Islamic Finance cases continue to be decided under secular law, to the exclusion of *Shari'ah*, legal ambiguity will continue to hinder sustainable long-term growth. Separately, IFI-drafted governing law clauses that have the foreseeable effect of excluding *Shari'ah* suggest a lack of commitment to *Shari'ah* and its enforcement. As the trial judge noted in *Shamil*: "The English court, as a secular court, is not suited to ascertain and determine highly controversial principles of religious-based law and it is unlikely that the parties would be satisfied with any such ruling; that is not what they were wanting by their choice of law clause."²¹

Shari'ah Board Reports: Disclosure Quality and Brand Management

As succinctly stated by the Islamic Financial Services Board (IFSB): "Compliance with *Shari'ah* rules and principles is the *raison d'être* of the Islamic Financial Services Industry."²² *Shari'ah Board Reports* (SBRs) issued by IFIs should reflect this existential truth, in two ways. First, IFIs should ensure that their SBRs fully describe the *Shari'ah* governance apparatus in place, to communicate to consumers, shareholders, regulators, and the public the importance and role of *Shari'ah* governance at the IFI level. Second, SBRs are an excellent marketing medium for IFIs, and they should be used to bolster the Islamic brand.

- Bolster the Level of Disclosure in SBRs.* IFI SBRs tend to share a common structure. First, they state that operations complied with applicable *fatawa* and *Shari'ah* generally. Second, they assure readers that all profits derived from non-*Shari'ah*-compliant transactions were set aside and paid as *zakat* (charity). Third, SBRs usually reiterate that responsibility for governance, including *Shari'ah* governance, rests with IFI management. Fourth, SBRs typically state that the *Shari'ah Board* discharged its oversight functions based on information and documentation (e.g., audit reports) provided by IFI management. Finally, the signatories

²⁰ In *Shamil*, the disputed agreement contained a governing law provision stating that: "Subject to the principles of the Glorious *Shari'ah*, this agreement shall be governed by and construed in accordance with the laws of England." *Shamil* at para. 1. The English court did not apply *Shari'ah*, because under English law, the law of decision in English courts must be a law of another country, and not a "non-national" system of law. Therefore, the *Shamil* case was decided under English law, even though, as noted, the English Court in that case commented that the outcome likely would have been different if *Shari'ah* had applied.

²¹ *Shamil* at para. 36.

²² *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*, ISLAMIC FINANCIAL SERVICES BOARD, December 2009, available at, <http://www.ifsb.org/standard/IFSB-10%20Shari'ah%20Governance.pdf> (last accessed October 2010).

of SBRs often are scholars known to have held multiple Shari'ah board positions during the reporting year. These five common features highlight places where disclosure can be enhanced, along the following lines:

- o The nature of the Shari'ah governance apparatus in place (e.g., the manner in which Shari'ah compliance audits are conducted and their frequency, clarity as to whether the Shari'ah Board itself reviewed documentation (e.g., by sampling) or relied on summaries of documentation).
 - o Information about the human, technological, and departmental resources that are devoted to Shari'ah compliance, etc., and their place in the IFI's organizational structure.
 - o The setting aside of improperly gained profits is itself an element of Shari'ah compliance. However, disclosures of such instances must be reasonably explained and accompanied by details of remedial measures that were or will be implemented to avoid or reduce instances of non-compliance in the future.
- *The SBR as Marketing Tool.* SBRs serve necessary (and in jurisdictions where they are required by regulation, mandatory) functions. But they also should be used proactively as marketing tools. SBRs provide IFIs with a rare opportunity to educate a diverse pool of readers about the nature of their business model and objectives, and to differentiate their brand. Using SBRs as effective marketing tools requires that they be written eloquently and thoroughly, to achieve the purpose of informing readers about the importance of Shari'ah governance, the Shari'ah governance processes in place within the publishing IFI, the commercial and ethical objectives of Islamic Finance, and distinctions between IFIs and their conventional counterparts, etc.

The Role of Shari'ah Boards

- *Empowering Shari'ah Boards.* Shari'ah Boards sit at the narrow apex of the Shari'ah compliance pyramid. They make and interpret the rules, and they are charged with a degree of oversight. But, with few exceptions, they are not full-time employees of the IFIs which they serve. IFIs must ensure that Shari'ah Boards are equipped with the resources necessary to discharge their duties. Such resources might include assigning full-time, dedicated Shari'ah governance personnel (e.g., legal counsel, compliance professionals, accountants, etc.) with responsibility for reviewing documentation, audit reports, and transactions on a regular basis. Such dedicated Shari'ah Board personnel should report directly to the Shari'ah Boards that they serve, and should have a meaningful degree of independence from other operating units of IFIs.

4. Industry-Level Facilitative Measures: Building a Specialized Legal Infrastructure

Many industry participants and observers have called for binding standardization to promote predictability and transparency in Islamic Finance. Whether standardization is a feasible and wise option in the near-term is open to debate. In the meantime, other measures can be taken to promote predictability and transparency.

- *Facilitate Development of Contemporary Islamic Economic Law.* *Shamfi* and *Blom* are two of many cases involving IFIs that have been tried in secular courts. Frequent and widespread resort to secular fora, over the long term, will stunt the development of contemporary Islamic economic law. As demonstrated by the *Shamfi* case, secular courts will not always apply religion-derived law to settle disputes. The result is that modern Islamic economic instruments are not being soufinitized under the laws with which they purport to comply, thus perpetuating legal ambiguity.

- Specialized Dispute Resolution Fora. As Islamic Finance continues to grow, so will the number of disputes. The need is clear for specialized fora to resolve Islamic Finance disputes, accommodate parties, and facilitate the transparent development of contemporary Islamic economic law. The accumulation of legal decisions through such fora would engender standardization of norms, without the potentially negative consequences of standardizing rules based on insufficient industry experience. Of course, any such specialized fora, to be viable, must offer a degree of transparency, predictability, and efficiency on par with English and other secular systems, with the much needed benefit of substantive *Shari'ah* expertise.
- Shari'ah Expert Vetting, Training and Roles. In the *Shamfi* case, as in others involving Islamic law and tried in secular fora, the services of Islamic legal experts were utilized. So long as Islamic legal experts are needed, the Islamic Finance Industry has an interest in ensuring that persons acting as Islamic banking and finance experts are qualified to do so. Relatively modest measures can be taken to promote and maintain quality amongst experts. For example, training and certification programs and the creation of a register of experts through such programs. Of course, measures would be necessary to ensure that such measures do not have the undesirable effect of excluding any *Shari'ah* interpretations or points of view, as long as competency is guaranteed.

Conclusion

Without question, contemporary Islamic Finance has grown tremendously in a short period of time. This growth and the raised visibility that has accompanied it present challenges and opportunities. Islamic Finance has reached the point of maturity at which introspective questions about its essence and place in the world of financial services must be asked and considerately answered. Unanimity of opinion among industry participants and observers as to the future of Islamic Finance is unlikely. Whatever the outcome, the path to sustainable growth must begin with operational excellence, which is the key to unlocking lasting value in Islamic Finance.