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SYNOPSIS

As Islamic Finance continues to grow against the backdrop of a shuddering conventional banking system beset with ailments peculiar to leverage, this article looks at the fundamental principles and legal structures behind Islamic financing and considers whether, in exchange for genuine participation in quantifiable risk, Islamic investment offers a safer, resilient and more stable ethical alternative. This article also addresses how conventional constructs, when used in Islamic form via the doctrine of hiyal (legal fiction or stratagem), threaten the spiritual foundational basis on which Islamic finance rests: The unequivocal aversion to risk free returns (riba).

INTRODUCTION

We live in interesting times. Old certainties of conventional finance have proven tenuous, leaving behind an unprecedented financial crisis and a massive loss of confidence. Hardly any institution or investor has been immune to the turmoil, but in the last year many Islamic

* Oliver Ali Agha is a founding partner of Agha & Shamsi, a Shari'ah-compliant legal consultancy based in Abu Dhabi. With many years of professional experience in the field including having served as the Global Head of Islamic Finance at DLA Piper based in Dubai and at Clifford Chance's Saudi affiliate in Riyadh, Oliver Ali Agha has been recognized by multiple publications (including Chambers, Legal 500, Who's Who Legal and IFLR Best of the Best Islamic Finance Lawyers 2008 and 2009) as a leading Islamic finance expert and practitioner. He was noted as one of the top 20 lawyers who assisted the Gulf's economic boom and is a frequent commentator on TV, radio and speaker at conferences. He is on the board of AAOIFI (the Accounting and Auditing Organization for Islamic Financial Institutions), a supra-national Islamic finance standard setting body. This article expands on a presentation entitled "Introduction to Islamic Finance" that Mr. Agha delivered during the 2nd Annual UC Berkeley Islamic Finance Symposium on Feb. 28, 2009.

investments and institutions have weathered the storm in better shape than those of conventional banking markets. Islamic investments are asset-based because of prohibitions against interest-bearing loans and bifurcation of debt from assets, and have therefore remained relatively sheltered from the worst shocks of the financial markets.¹ The current financial turmoil has in many cases been caused by conventional financiers' poor risk-management decisions, over-leverage, and sale of debt and, in this context, Islamic financial products and institutions are gaining increased credibility and popularity as safe havens for investors.

Does Islamic finance herald a system that gives its participants real returns derived from an ethically-based framework? Islam puts principle before profit. While it is important to succeed in this world, such success must not be at the cost of the means to success. In short, the means justify the ends. Participants must receive profits from activities that are inherently beneficial to society—by definition they cannot be exploitative, speculative, or based on a riskless return. The “risk” of a borrower defaulting and inadequate collateralization does not meet the threshold of required risk. Further riskless return where this is coupled with guarantees or security is considered to be inherently exploitative.

While there is a greater risk element in Islamic financing as it, at its core, envisions *musharaka* (partnership) arrangements and venture capital-type investments, there is much room for the development of compliant products that would serve the diverse needs of a community while preserving the strict prohibition against usury. Islamic finance is a spiritually-based approach to finance for which the time may have come. However, Islamic finance struggles to break free of the conventional banking mould, as many Islamic products are Islamic only in form and not in substance. The greatest challenge that lies ahead for Islamic finance is whether it will break free of the chains of *riba* or permit an accommodation of *riba* that will eventually be its undoing.

II. WHAT IS ISLAMIC FINANCE?

“Islamic Finance” means conducting finance in accordance with the principles of Islam. Making money is permissible – to be encouraged even - but it must be made in a principled way. The underlying intention is to engage the Islamic financier effectively as a partner and co-owner,

1. Soren Billing, *Islamic Investments Could Weather the Financial Storm*, ARABIAN BUSINESS.COM, Dec. 3, 2008, <http://www.arabianbusiness.com/540209-islamic-investments-could-weather-financial-storm>.

to encourage the taking of genuine risks. As a result, simply lending money at a fixed rate of return and taking an inadequate part of the business risk is prohibited.

Because conventional products base themselves on interest (*riba*), or risk-free guaranteed returns, they are antithetical to Islamic finance. As Islamic finance develops, the knee-jerk reaction has been to ‘replicate’ conventional products in Islamic garb. Consequently, there has been a huge upsurge in the number of products that are purported to be Shari’ah compliant and which are becoming increasingly sophisticated.

III. PERMISSIBILITY AND IMPERMISSIBILITY

At the heart of Shari’ah’s ability to respond to modern financial circumstances lies the philosophy that all is permissible, except for that which has been expressly or analogously prohibited. As a result, the ability of the parties to decide on novel constructs and legal forms is largely unfettered, which allows the parties to come to commercial terms with ease. However, what is impermissible is clearly set forth.

The most relevant prohibition in Shari’ah is the prohibition against usury, otherwise known as interest or *riba*. The source of this prohibition stems from the Qur’an itself:

Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitteth trading and forbiddeth usury. He unto whom an admonition from his Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returneth (to usury) - Such are rightful owners of the Fire. They will abide therein.²

A Prophetic hadith further equates the depth and breadth of *riba* (usury) with shirk (idolatry): “*Riba* (usury) has over seventy kinds and shirk (idolatry) is like that.”³ This language reveals the extreme extent to which Islam discourages usury. Other religions have shared this disdain of usury. Interest taking is deemed to be the denial of Yahweh in Judaic thought.⁴ Further, Christian theologians have similarly deemed

2. QUR’AN 2:275.

3. IBN MAJA, KITAB AL-TIJARAT, hadith 2275.

4. Gemara of Jerusalem Talmud, Baba Mezi’a, V, Ild (Bonsirven 462), *quoted in* Azeemuddin Subhani, Adjunct Asst. Professor, Univ. of Waterloo, “Islamic Financial Theory: New Critical Perspective,” Address at the Eighth Harvard University Forum on Islamic Finance: Innovation and Authenticity (April 19, 2008). Professor Subhani notes, “Similarly, the Gemara of the Jerusalem Talmud declares interest taking as denial of

interest-based lending to be Satan's revenge for the collapse of paganism.⁵ One Islamic scholar has shown that the act of usury—making money from money—is tantamount to *ex-nihilo* creation, self-generation or self-subsistence, and hence a transgression into the domain of the divine.⁶

Another prohibition is uncertainty. In particular, Islamic tradition warns against the uncertainty that may result in the detriment of one of the parties.⁷ This does not mean that all future contracts are completely invalid under Shari'ah. One does, however, have to consider the risk of not being able to fulfill that contract since the Qur'an states: "O ye who believe! Fulfill your undertakings."⁸ Further, speculation and engaging or contracting in impermissible areas, such as gambling, alcohol, pork and tobacco production are similarly proscribed.

IV. THE HILA: TODAY'S HYDRA IN ISLAMIC FINANCE

At the heart of the controversy surrounding Islamic finance is the hila (Arabic plural: hiyal), or legal fiction or stratagem.⁹ A hila seeks to

Yahweh: Come and see the blindness of those who lend at interest: if anyone calls another an idolater, an incestuous man or a murderer, the other seeks vengeance on his life; but does not one who hired a notary and witness and tells them to attest [to a usurious contract] deny the Place? This brings out that everyone who lends at interest denies the Principle [of divine authority]." *Id.*

5. *Id.* "Satan was lamenting the collapse of his authority as a result of the recent disappearance of paganism. In order to recover his power, he is going to make use of lending at interest (rebitha): priests and monks will indulge in this practice, and it will be their undoing. Once they have begun it, their orthodoxy, their cult of the true God, will matter little. 'I do not mind,' exclaims the Devil, 'if the priest uses the interest he draws from his money to buy an axe with which to smash the temples of the gods! The love of gold is the greater idol than any idol of a god...It is worth as much to me as all those idols put together. They have cast down the idols, but they will never cast down the coins that we shall put in their place...' Jacob of Saroug (c451-521), the Syrian Monophysite Bishop, in a sermon in Syriac."

6. *Id.*

7. For example, do not buy fish in the sea or an unborn calf. Abdullah Ibn Mas'ud narrated that the Prophet said: "Do not buy fish in the water because it's uncertain." 1 MUSNAD AHMAD 288.

8. QUR'AN 5:1.

9. Imam Abu Hanifa is reported to have said: "It is prohibited to intend to suspend rules overtly but the suspension of such rules implicitly is not prohibited." SHATIBI, 2 MUFAWAQAT 380. For example, the rule that states that a different legacy to heirs is not allowed unless the other heirs consent (because heirs receive according to a set formula) was altered by the Hanafi School using hiyal. This was because under a strict interpretation of the above rule, the admission of a debt to one heir on the deathbed could

effect form over substance. From the beginning of the recent upsurge in Islamic finance, loan agreements were aesthetically altered—the words “profit” were substituted for “interest” and such changes were considered sufficient to render a substantively conventional loan “Islamic.” Islamic jurists have been concerned, rightly, about the use of this *hila* because it lacks sufficient Qur’anic grounding. Scholars disapprove of using such a legal fiction because it results in a disguised interest-bearing transaction.¹⁰ Additionally, this tactic is deceptive and may constitute a form of hypocrisy; it enables potential third parties to participate in a non-compliant transaction with the false belief that it is a genuine transaction.¹¹

The main challenge now facing both the Shari’ah finance industry and the lawyers that advise it is to ensure that consistent and rigorous scrutiny is applied to all products purporting to be Shari’ah compliant. They must ensure that the label “Shari’ah-compliant” is only applied to those products where the substance of the transaction does not violate the various prohibitions and where the ends of the transaction are consistent with the underlying ethical basis of Shari’ah financing. This challenge is being played out currently on an international stage with the debate between form and substance. This debate has been characterized as the rivalry between the Malaysian Islamic finance market and the London and Middle East Islamic finance markets. Consistent international standards are needed in the long term in order to establish cross-border transactional standards and consumer confidence in Shari’ah investment. Such standards, if produced, would have to be based squarely upon Sadd

not be approved, unless all of the other heirs had consented to it. However, the Hanafi School reinterpreted this rule, creating a legal fiction/stratagem that allowed a person on their deathbed to admit the debt of a non-heir on “trust” for onward payment to the intended heir.

10. A sahih hadith attributed to the Prophet holds that the taker of interest, the payer, the scribe who writes the contract and the witnesses are all subject to condemnation for participating in a usurious contract: “Narrated by Abdullah ibn Mas’ud, the Apostle of Allah (peace be upon him) cursed the one who accepted usury, the one who paid it, the witness to it and the one who recorded it.” ABU DAWOOD, hadith 3327. Similarly, “Narrated by Ali ibn Abu Talib, Ali heard Allah’s messenger, peace be upon him, curse those who took usury, those who paid it, those who recorded it, and those who refused to give sadaqah.” AL-TIRMIDHI, hadith 2829.

11. See QUR’AN 61:3 (“Grievously odious is it in the sight of Allah that ye say that which ye do not.”). See also *id.* at 3:167 (“And the Hypocrites also. These were told: ‘Come fight in the way of Allah, or (at least) drive (The foes from your city).’ They said: ‘Had we known how to fight, we should certainly have followed you.’ They were that day nearer to Unbelief than to Faith, saying with their lips what was not in their hearts but Allah hath full knowledge of all they conceal.”).

adh-Dharai principles, and the use of hila strictly limited in order to avoid Islamic finance simply becoming conventional finance in a different wrapper.¹²

The work of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and its Secretary General, Dr. Mohamed Nedal Alchaar is one bright spot on the map of Islamic finance. AAOIFI is the leading Islamic supra-national authority based in Bahrain and has a Shari'ah board that is populated with the leading scholars. AAOIFI has continued, despite tremendous pressure, to stick to the principle of substance over form, and issues Shari'ah standards that set the bar for genuine Islamic finance. Seven jurisdictions have adopted AAOIFI's standards and six more have recognized them. Recently, AAOIFI has expressly ruled that practitioners must scrutinize Islamic transactions to ascertain that the structures comply with substance of the Islamic rule as well as form.

What follows is an exposition of the main types of Islamic finance products, with an emphasis on their core ethical and legal tenets. It is the substance of these transactions that needs to be regulated, to come under AAOIFI guidelines, so as to prevent the dilution of transactions and risk the loss of their credibility as genuine alternatives to conventional finance.

V. SHARI'AH INVESTMENT VEHICLES

Given the sophisticated and flexible jurisprudence of Shari'ah law, it is no surprise that practitioners have developed a large number of investment vehicles to meet modern finance requirements, while holding true to the basic tenets of Shari'ah financing: the ban on riba and prohibited forms of trade.

12. The reaction to the hiyal doctrine and to Imam Abu Hanifa was strong and generally collective. Broadly speaking, the other Schools rejected the doctrine of hiyal. In the view of others, the whole purpose of the rules of Shari'ah is to prevent the use of otherwise permissible legal instruments and rules as tools to achieve morally questionable outcomes. Put simply, the means justify the ends. The doctrine Sadd adh-Dharai means that actions that lead to an impermissible result are prohibited and authority for such is rooted in the Qur'an itself: "Do not curse the gods of those who worship other than Allah lest they curse Allah without knowing." QUR'AN 6:108. While one may "curse" the gods of idolaters, such action is forbidden because taking the action may result in others cursing Allah without knowing the impact of their utterances. To dig a well is permissible but to dig it too close to your neighbor's wall so as to collapse or damage his wall is impermissible.

The defining element behind all Shari'ah investment is participation in risk and reward and, as stated above, it is this that distinguishes Shari'ah investment from interest-based conventional finance. Accordingly, Shari'ah investment requires that the financier participate in the business risk through the medium of partnership. The investor's active participation is encouraged by the hope that through joint endeavors the enterprise will do well. This is the philosophy behind the most common method of Shari'ah finance: Musharaka.

1. The Partnership: Musharaka

A musharaka is a partnership between two or more entities or persons whereby each contributes cash or assets toward a venture. As a result, the profits are shared in pre-agreed proportions and because of the prohibition on undue reward, the parties must assign each partner an award that corresponds to his contribution of the cash or asset warrants. However, scholars generally permit profit sharing out of pro-rata proportion subject to certain requirements.¹³

As in all usual partnerships, losses must be shared in the same proportion that the assets are contributed, and so the parties share a consistent risk of reward and loss.

An example of the technique of hila in the context of a musharaka would be where Partner A guarantees the capital or return of Partner B. Such an arrangement would be a musharaka in form but a disguised loan in substance.

2. The Limited Partnership: Mudaraba

Where limited partnerships constructs are required, parties employ the mudaraba—the limited partnership. This is a partnership in profit, but—for the passive partner—not in liability.

The mudaraba derives its origin from the Sunnah when Umar Ibn Khattab gave a well-known Iraqi trader funds belonging to an orphan for the purpose of investing. The party providing the capital is referred to as the Rabb Al Mal while the other party who provides the expertise and labor is referred to as the Mudarib.

In this form of partnership, the Mudarib's liability is limited to losses caused by his or her negligence. The business risk of failure is

13. AAOIFI STANDARD 12, SHARIKA (MUSHARAKA) AND MODERN CORPORATIONS 3.1.3.4, 3.1.5.3, 3.1.5.4, 3.1.5.5 and 3.1.5.9 (1429H / 2008G).

borne by the Rabb Al Mal while the custody and control of the assets is under the Mudarib. Profits are distributed entirely according to a pre-agreed ratio of the parties.

Through the use of hila, a guarantee is built into the agreement where the Mudarib guarantees a minimum income from the investment to the Rabb Al Mal, effectively creating a riba instrument. Moreover, where the Rabb Al Mal retain any management or non-passive partner attributes, they become subject to unlimited liability irrespective of the contractual arrangements, because active partners become liable for losses while passive partners do not. This renders the mudaraba into a musharaka, *ab initio*, a most commercially undesirable effect. Naturally, any mudarabas that effect such an arrangement are Islamic in garb but conventional in fact.

3. *The Deferred Payment Sale: Murabaha*

A financing method that assures a fixed rate of return is the murabaha arrangement, which takes effect as a deferred payment sale. Under this arrangement, an investor, which may be a bank, buys goods at a disclosed price, takes physical or constructive possession and title to them, adds a pre-agreed margin (mark-up), and then sells at the marked-up price, and transfers title, to the buyer. The buyer has a deferred obligation to pay the price, which must be fixed and agreed upon in advance, in a lump sum or in installments.

The investor may take security from the buyer if he or she feels it necessary, but title to the goods remains with the buyer of the goods, and so the investor cannot easily take possession of the goods if the buyer fails to pay back on time.

While this is a genuinely Islamic financing method, where this construct results in arrangements where commodity transactions (on paper) are conducted and the “buyer” has a variable payment for such goods that are tantamount to interest payments in a conventional loan, scholars have raised the issue that this is yet another variant of hiyal rearing its head as a wolf in sheep’s clothing because the commodity transactions are being devised to effect a conventional loan arrangement.

4. *The Lease: Ijara*

An ijara is an Islamic lease. This is often used as a financing lease. The parties agree to the lease terms including the installment amounts and payment dates. At the end of the term, the investor may sell the

asset to a third party or to the lessee, depending on what arrangements the parties have made.

In ijara contracts, the issues to consider are: (i) the sale and leaseback arrangements: Is the asset being sold and then leased back to seller for a guaranteed return to buyer? (ii) Are the rental payments out of line with fair market value? (iii) Is there an obligation on the lessee's part to purchase the asset in the event of uninsured force *majeure* or other uninsured risk of loss occurrence? If the answer to some of the above is "yes," then the fabric of the ijara arrangement may be questionable from a Shari'ah standpoint and should be scrutinized.

5. Issuer's Certificates: Sukuk

Sukuk (Arabic singular: sakk) are issuer's certificates representing an undivided share in the ownership of tangible assets that are not receivables. The general principle regulating this investment is that the certificates themselves represent an undivided share in the pot of assets held. True sukuk are backed by tangible assets, usufruct or services.¹⁴ Sukuk are not debts owed to certificate holders by the issuer of the sukuk certificates; referring to sukuk as 'Islamic bonds' is an oxymoron.

Because the sukuk must be backed by tangible assets, usufruct or services, sukuk certificates cannot represent receivables, as these are trades in debts. Generally debts may not be traded under Shari'ah principles.

Where the sakk replicates the conventional bond profile, it violates Shari'ah principles. Muhammad Taqi Usmani, President of the AAOIFI Shari'ah Board, believes that most of the market sukuk were un-Islamic and voiced concerns about the legitimacy of the market practice of sukuk where, for example, the sukuk arrangement contains a binding promise on the part of the issuer to repurchase assets at their original value, regardless of the market value of those assets at maturity.¹⁵ Again, where *hiyal* results in sukuk being subverted into conventional bonds, the distinction between Islamic and conventional finance blurs.

14. It is a matter of some controversy whether services may be regarded as tangible assets.

15. MUHAMMAD TAQI USMANI, *SUKUK AND THEIR CONTEMPORARY APPLICATIONS* (Yusuf Delorenzo, transl. 2007).

6. Insurance: Takaful

Takaful is a Shari'ah-compliant insurance scheme operated on the basis of shared responsibility and mutual obligation to safeguard its participants against a defined risk. This is an area that has attracted controversy, although the increasing mainstreaming of takaful insurance products suggests that the controversy is starting to abate.

One formalist school of thought has generated controversy over this form of investment, suggesting that alleviating future risk is "uncertain" and therefore impermissible to contract upon. Similarly, some have asserted that making a future provision through insurance is contrary to the will of the divine. In relation to this latter point, the author and scholars believe that alleviating risk is not necessarily contrary to the will of Allah and note the hadith¹⁶ and passages in the Qur'an that suggest that believers should take a pro-active approach to risk.¹⁷ However, it has been the proposed solution to the issue of "uncertainty" in insurance that is yet another example of hila.

The solution to circumvent uncertainty has been for the insured to donate the premium (expecting nothing back) and the insurer to donate the event-of-loss amount back upon occurrence of an insured event. Since two unilateral obligations are occurring – each in and of itself discrete – uncertainty is said to be avoided. However, donation under Islamic law requires complete relinquishment of all rights and expectation of return, so the usage of hila in the above case renders these contracts unenforceable. The "uncertainty" sought to be avoided is in fact enabled through the use of hila.

In my opinion, and that of some other leading scholars' in the takaful field, takaful has independent legitimate basis and does not require legal fiction to validate its existence. This stems from the golden rule that that which is not prohibited is permissible and is buttressed by verses and hadith.¹⁸

16. "The Holy Prophet told a Bedouin Arab who left his camel untied, trusting to the will of Allah, tie the camel first, then leave it to the will of Allah..." SUNNAN AL-TIRMIZI 668.

17. "...Allah intends every facility for you and He does not want to put you in difficulties..." QUR'AN 2:185.

18. *Id.* See also SUNNAN AL-TIRMIZI, *supra* note 16.

CONCLUSION: ISLAMIC FINANCE, PRINCIPLE BEFORE PROFIT

In current times, Islamic finance has seen unprecedented growth. It stands to grow and become a viable alternative to conventional finance. Islamic finance has a noble prescription for humanity – cooperative and ethical finance in societies where persons strive for success but do so within the bounds of ethical and principled consideration. It demands the scrutiny of exploitative and adversarial contracts and speculative or solely profit-minded motives. While there are some structures and transactions that approach the true goals of Islamic finance, there is a long way to go for Islamic finance to realize its goals of becoming a non-speculative, non-exploitative and genuine risk-sharing venture. The fabric of Islamic finance, however, is caught in the hands of modern day hydra of hiyal and its true success, in my view, will be judged not by the year-on-year percentage growth compared to conventional finance but according to how closely products adhere to the spiritual rules they purport to follow.