THE LAW OF ISLAMIC FINANCE IN THE UNITED KINGDOM: LEGAL PLURALISM AND FINANCIAL COMPETITION

BY

JONATHAN G. ERCANBRACK

SCHOOL OF LAW

SCHOOL OF ORIENTAL AND AFRICAN STUDIES (SOAS)

UNIVERSITY OF LONDON

THESIS SUBMITTED FOR THE PHD IN LAW

15 SEPTEMBER 2011

DECLARATION FOR PHD THESIS

I have read and understood regulation 17.9 of the Regulations for students of the School of Oriental and African Studies concerning plagiarism. I undertake that all the material presented for examination is my own work and has not been written for me, in whole or in part by any other person. I also undertake that any quotation or paraphrase from the published or unpublished work of another person has been duly acknowledged in the work which I present for examination.

Signed by,

Jonathan G. Ercanbrack

15 September 2011

DEDICATION

I would like to thank my wife, Anna, and my daughter, Saskia, for putting up with me these past four years. I could not have completed this thesis without their love and support. Furthermore, I owe a great deal to my supervisors, Professor Peter Muchlinski and Mr Nicholas HD Foster, who devoted countless hours to my supervision and, most importantly, pushed me to achieve my best.

I also wish to thank the William Ballantyne Fund and the School of Oriental and African Studies for generous grants, without which I would not have been able to carry on.

ABSTRACT

The extant literature concerning the Law of Islamic Finance (LIF) is dominated by illustrations of Islamic financial contracts and critiques of the way in which the sharia has been circumvented. Much less emphasis has been placed on understanding the regulatory and financial environment in which the LIF is formed and practiced. This thesis considers the challenges in formulating and implementing a modern, transnational LIF in the conventional financial and legal environment and offers solutions to these problems. It demonstrates the way in which the classical sharia is transformed by these challenges into a LIF, a hybrid law resulting from pluralistic legal interaction and financial competition. In assessing the manner and impact of implementing the LIF in the United Kingdom, the thesis considers the interaction of the sharia with English law, UK financial services law and international regulatory standards. Comparative law methodology, with a particular emphasis upon legal pluralism and legal transplants, are employed.

The sharia, a relatively stateless law, is the inspiration behind Islamic financial contracts. Dominated by transnational corporate interests, Islamic financial *ijtihād* represents the strategy to adapt conventional financial contracts to sharia criteria. The results are hybrid structures that conform to Islamic legal theory but which generate municipal legal challenges in practice, as well as sharia-compliance risks. Such structures have been integrated in English law with the creation of tax exemptions and novel regulatory classifications that treat these structures as loan arrangements and debt-based instruments. Furthermore, Islamic financial transactions are subject to UK financial services regulation, which itself incorporates European Union financial directives and Basel Capital Adequacy Standards. Finally, Islamic financial contracts, which are often governed by English law, face challenges in English courts concerning parties' choice of the sharia as the proper law of their contract. Arbitration, on the other hand, offers parties the

autonomy to choose the sharia as the substantive law of their contract and to have it enforced under English law.

The wide range of challenges in articulating and implementing a LIF demonstrate the hybrid nature of the law, resulting from pluralistic legal interaction in modern financial markets. This pivotal insight may encourage scholars and practitioners to revise their conception of the LIF and, by extension, their view of the industry and its financial practices. In sum, the LIF is a modern, transnational law that derives its inspiration from the classical Islamic tradition of commerce but which has been innovated in ways that distinguish it as an emergent law in its own right.

ABBREVIATIONS

AAOIFI: Auditing and Accounting Organisation for Islamic Financial Institutions

AB: Advising Bank

AFIB: Alternative Finance Investment Bond

BCBS: Basel Committee on Banking Supervision

BIS: Bank for International Settlements

CAR: Capital Adequacy Requirement

CE: Common Era

CDO: Collateralised Debt Obligation

CIS: Collective Investment Schemes

DCR: Displaced Commercial Risk

DGS: Deposit Guarantee Scheme

DIFC: Dubai International Financial Centre

EC: European Council

EEA: European Economic Area

ESUA: Exchange in Satisfaction and User Agreements

EU: European Union

FSA: Financial Services Authority

FSCS: Financial Services Compensation Scheme

FSMA: Financial Services and Markets Act 2000

GCC: Gulf Cooperation Council

HMRC: Her Majesty's Revenue and Customs

HPP: Home Purchase Plan

IAB: International Accounting Board

IAH: Investment Account Holders

IB: Issuing Bank

IBB: Islamic Bank of Britain

ICC: International Chamber of Commerce

ICTA: Income and Corporations Tax Act

IDB: Islamic Development Bank

IDR: Issuer Default Rating

IFI: Islamic Financial Institution

IFRS: International Financial Reporting Standards

IFSB: Islamic Financial Services Board

IFSL: International Financial Services London

IIC: Islamic Investment Company

IIFM: International Islamic Financial Market

IILM: International Islamic Liquidity Management Centre

IIRA: International Islamic Ratings Agency

IMF: International Monetary Fund

INCOTERMS: International Commercial Terms

IOSCO: International Organization of Securities Commissions

LIBOR: London Interbank Overnight Rate

LIF: Law of Islamic Finance

LMC: Liquidity Management Centre

LSE: London Stock Exchange

MENA: Middle East and North Africa

MLIF: Municipal Law of Islamic Finance

NS&I: National Savings & Investments

OECD: Organization for Economic Cooperation and Development

OIC: Organization of the Islamic Conference

PLS: Profit- and loss-sharing

PRA: Prudential Regulatory Authority

PSIA: Profit-sharing and investment account

RAO: Regulated Activities Order

SDLT: Stamp Duty Land Tax

SG: Symphony Gems

SPL: Sanghi Polyesters Ltd.

SPV: Special Purpose Vehicle

SSB: Sharia Supervisory Board

TCF: Treating Customers Fairly

TID: The Investment Dar Company

TII: The International Investor

TNC: Transnational Corporation

UAE: United Arab Emirates

UK: United Kingdom

UNCITRAL: United Nations Commission on International Trade Law

US: United States

VAT: Value Added Tax

WTO: World Trade Organisation

Note: The transliteration of Arabic words into the Roman script has been undertaken according to the Library of Congress transliteration standard. For the sake of simplicity, most singular Arabic words have been given an English 's' to denote the plural form. Words such as *sukuk*, however, which are often used in modern financial markets, are used in the plural. Finally, Arabic words which, according to the Oxford English Dictionary, have been borrowed into the English language have not been transliterated or italicised. Such words include the sharia, Hadith, Sunna and others.

ARABIC-ENGLISH GLOSSARY

'Ādat at-tujjār:	practice of the merchant/trader
'Adhāb:	punishment, chastisement
'Ahd:	obligation, covenant, treaty, agreement
'Aqd:	contract, covenant
'Amal:	labour; action, performance
Amānah:	trust, faithfulness
'Ariyah:	loan
Arkān (pl.):	component(s), pillar(s) (of a contract)
Aṣḥāb al-hadith:	people of the Hadith (traditions); term associated with the Mālikīs
'Ayn:	a corporeal matter, substance
Bāṭil:	void (legal)
Batīn:	inner meaning or interpretation
Bay' :	sale
Bay' al-dayn:	sale of debt
Bay' ghā'ib:	contract of sale for an absent thing or object
Bay' al-'īnah:	double sale used to circumvent the prohibition of lending with interest
Bay' al-wafā':	a contract in which the owner of property (house or land) sells it, with the condition that that he will repurchase the property for a larger sum than the original price.

Bidʻa: innovation

Dalīl: sign, indication
Ḍarūrah: necessity, need
Dayn: obligation, debt; also expresses the idea of “claim” or right
Dhimmah: capacity, personal responsibility or obligation
Fā’ida: interest; growth
Faqīh (sg.) /Fuqahā’ (pl.): Expert in Islamic jurisprudence (fiqh)
Farḍ: obligatory
Fāsid: defective (legal)
Faskh: rescission of a contractual bond
Fatwa: legal opinion
Fiqh: Islamic jurisprudence
Fiṭra: the native ability to know of God’s existence
Furū: branches of jurisprudence; whereas the uṣūl al-fiqh indicates the roots of the law

Gharar: excessive risk/speculation

Hadith: narration of the words and deeds of the Prophet Muhammad
Ḥalāl: lawful
Ḥarām: forbidden
Ḥawālah: transfer of debt
Hibah: gift
Hijra: the emigration of the Prophet Mohammed from Mecca to Medina in 622 CE
Ḥīlah (sg.)/ḥiyal (pl.): legal stratagem

‘Ibādāt: devotional worship (e.g. prayer, fasting)
Ibāhah: permissibility
Ījāb: offer
Ijārah: lease
Ijārah wa-iqtinā’: financial lease

Ijmāʻ: scholarly consensus
Ijtihād: independent reasoning
Ikhtilāf: disagreement, difference of opinion
Ikhtiyār: option, choice, preference
ʻIllah: effective cause. The element utilised in establishing a connection between the holy sources, the Quran and Sunna, and a novel case requiring independent juristic reasoning (ijtihād).
Irādah: human will
Isnād: chain of authorities (of a Hadith)
Istiḥsān: juridical or personal preference
Istiṣlaḥ: public benefit (technical legal term)
Istiṣnāʻ: contract of hire, manufacture

Jahl: want of knowledge; ignorance
Jāhilīyah: time of ignorance; pre-Islamic
Juʻālah: reward

Kafālah: guarantee
Khultah: mixed type of partnership
Kitāb: book
Kitāb al-ḥiyal: book of ḥiyal

Madhhab/Madhāhib: schools of law (Sunni schools of law: Shāfiʻi, Mālikī, Ḥanafī, and Ḥanbalī)
Mafsadah: evil
Majlis: (noun of place) indicating “a session” or “meeting, assembly”
Makhraj (sg.)/Makhārij (pl.): exit(s); Ḥanafī term for ḥiyal
Makrūh: reprehensible
Mal: property
Mandūb: meritorious, recommended
Manfaʻah: usufruct
Maqāṣid al-sharia: objectives of the sharia
Maṣlaḥah: public interest
Maysir: gambling

Mu'āmalāt:	transactions
Mubāh:	permissible, licit
Muḍārabah:	an investment partnership; also known as muqarāḍah and qirāḍ
Muḍārib:	investment agent
Mujtahid:	Islamic scholar who possesses the aptitude of performing ijtihād
Mukhāṭarah:	legal stratagem (ḥīlah), commonly associated with bay‘ al-‘īnah
Murābaḥah:	a sale with a mark-up (profit)
Mushārakah:	contractual partnership; participation financing
Mustaḥabb:	recommendable
Muzāra‘ah:	agricultural partnership
Naṣṣ:	a text whose presence in the Quran or Hadith must be demonstrated
Nīyah:	intention
Qabūl:	acceptance (contractual relation)
Qādī:	Islamic law judge
Qard ḥasan:	loan, a charitable loan (without interest)
Qaṣd:	human intention
Qirād:	sleeping partnership, also known as muḍārabah and muqarāḍah
Qiyās:	analogical reasoning (one of the four sources of Islamic law according to orthodox Sunni Islam)
Rabb al-māl:	investor (a partner in the muḍārabah contract)
Ra'y:	discretion (legal reasoning)
Ribā:	usury
Ribā al-faḍl:	ribā of excess
Ribā al-nasī'ah:	ribā by delay
Ribāwī:	ribā-based; illicit
Riḍan:	the fact of being pleased or contented; approval
Rukn (sg.):	component(s), pillar(s) (of a contract)
Sabab:	cause
Ṣadaqa:	voluntary contribution

Ṣadd al-dharā'i': blocking the means (legal principle)

Ṣakk (sg.)/Sukuk (pl.): cheque; Islamic bond, Islamic investment certificate

Salam: a forward sale (fungible commodity)

Ṣaḥīḥ: valid (legal)

Shahādah: witness; the declaration by which a believer professes her belief in the Islamic faith

Sharia: literally, the way; Islamic law

Shirkah/Sharikah: partnership

Sharikat al-milk: partnership based on joint ownership

Sharikat al-wujūh: credit partnership

Shurūṭ: legal formularies; also conditions or appendages to contracts

Sukuk al-ijārah: Islamic securitisation based on a lease

Sunna: the living tradition; the sayings and doings of the Prophet Muhammad (holy source)

Sūrah: chapter or segment indicating the way in which the Quran has been organised

Takāful: Islamic insurance

Takhayyur: eclectic choice (legal)

Talāq: pronunciation of divorce (by the man)

Talfīq: patching (a legal technique used to derive a novel legal opinion)

Taqlīd: juristic conformity in the period after "gates of ijtihād" were said to have been closed

Tashrī': refers to modern statutory legislation which incorporates elements of the sharia

Tawarruq: sale and re-sale transaction used to generate cash/liquidity

Thawāb: merit; compensation offered where not required

Ulema: religious scholars

'Umlah: commission

Ummah: community

'Urf: custom

Uṣūl al-fiqh:	the principles of jurisprudence (methodology)
Wakīl:	agent
Wakālah:	agency; investment contract in which agent represents investor(s)
Waqf:	charitable endowment
Waṣf:	attribute
Zakāh:	obligatory charitable contribution (Islamic law)
Ẓāhir:	outward meaning of a word, language or event

CASES

Amin Rasheed Shipping Corp v Kuwait Insurance Co, the Al Wahab [1984] AC 50, [1983] 2 All ER 884, [1983] 3 WLR 241, HL

Halpern v Halpern [2006] EWHC 1728 (Comm), [2006] 3 All ER 1139, [2006] 2 All ER (Comm 484, [2006] 3 WLR 946, [2006] NLJR 1137, (2006) Times, 18 July, [2006] All ER (D) 20 (Jul), QB; [2007] EWCA Civ 291, [2008] QB 195, [2007] 3 All ER 478, [2007] 2 All ER (Comm) 330, [2007] 3 WLR 849, [2007] 2 Lloyd's Rep 56, (2007) Times, 14 May, [2007] All ER (D) 38 (Apr), [2007] QB 88, CA

The Investment Dar Company KSCC v Blom Developments Bank Sal [2009] EWHC 3545 (Ch), [2009] All ER (D) 145 (Dec)

Islamic Investment Co Ltd v Symphony Gems NV [2002] All ER (D) 171 (Feb), QB; [2009] EWHC 2378 (Comm), [2009] All ER (D) 07 (Oct), [2008] All ER (D) 141 (Mar), (2008) Times, 4 April, CA

Law Debenture Trust Corp Plc v Elektrim Finance BV [2005] EWHC 1412 (Ch)

Lloyds and Scottish Finance Ltd v Prentice (1977) 121 Sol Jo 847

Mahonia Ltd v JP Morgan Chase [2004] EWHC 1938 (Comm), [2004] All ER (D) 10

Musawi v Re International Ltd [2007] EWHC 2981 (Ch), [2007] All ER (D) 222 (Dec)

Nea Agrex SA v Baltic Shipping Co Ltd [1974 N. No. 2011] - [1976] QB 933, [1976] 2 All ER 842, [1976] 2 WLR 925, [1976] 2 Lloyd's Rep 47, [1976] 120 Sol Jo 351

Olds Discount Co Ltd v John Playfair Ltd [1938] 3 All ER 275, [1938] 82 Sol Jo 648, [1938] 159 LT 332

Petroleum Development Ltd v Sheikh of Abu Dhabi [1953] 47 AJIL 156.

Re George Inglefield Ltd [1933] Ch. 1, [1933] 101 LJ Ch 360, [1933] 147 Lt 411, [1933] 48 TLR 251, 536, [1932] All ER Rep 244, [1931] B & CR 220

Ruler of Qatar v International Marine Oil Company Ltd [1953] 20 Int LR 534

Sanghi Polyesters Ltd v the International Investor KCSC, [2000] WL 389643, [2000] All ER (D) 93, [2000] 1 Lloyd's Rep 480, [2001] CLC 748

Saudi Arabia v Arabian American Oil Co (Aramco) [1958] 27 Int LR 117

Shamil Bank v Beximco Pharmaceuticals Ltd [2003] EWHC 2118, [2003] All ER (Comm) 849, [2003] All ER (D) 25 (Aug), QB; [2004] EWCA Civ 19, [2004] 2 All ER (Comm) 312, [2004] 4 All ER 1072, [2004] 1 WLR 1784, [2004] 2 Lloyd's Rep 1, [2004] 08 LS Gaz R 29, (2004) Times, 3 February, [2004] All ER (D) 280 (Jan), CA

Stafford Allen & Sons Ltd v Pacific Steam Navigation Co [1956] 2 All ER 716, [1956] 1 WLR 629, [1956] 1 Lloyd’s Rep 495, [1956] 100 Sol Jo 431

Uddin v Choudhury [2009] EWCA Civ 1205

Welsh Development Agency v Export Finance Co Ltd [1990] BCC 393, [1991] BCLC 936, (1991) Times, 28 November, Ch D; [1992] BCLC 148, [1992] BCC 270, CA.

STATUTES AND STATUTORY INSTRUMENTS (UNITED KINGDOM)

Arbitration Act 1996

Bank of England Act 1998

Companies Act 2006

Consumer Protection from Unfair Trading Regulations 2008, SI 2008/1277

Contracts (Applicable Law) Act 1990

The Employment Equality (Religion or Belief) Regulations 2003, SI 2003/1660

Finance Act 2003

Finance Act 2005

Finance Act 2006

Finance Act 2007

Finance Act 2009

Financial Services and Markets Act 2000

Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/544

Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2006, SI 2006/2383

Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010, SI 2010/86

Fraud Act 2006

Income and Corporation Taxes Act 1988

Unfair Contract Terms Act 1977

The Unfair Terms in Consumer Contracts Regulations 1999, SI 1999/2083

Trade Descriptions Act 1968

STATUTES (FRANCE)

Loi No. 2010-1192 Du 11 Octobre 2010 Interdisant La Dissimulation Du Visage Dans L'espace Public (1)

EU TREATIES AND LEGISLATION

Council Directive 77/388/EEC of 13/6/1977 on the harmonisation of the laws of Member States relating to turnover taxes – common system of value added tax: uniform basis of assessment [1977] OJ L145.

Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC [1989] OJ L311

Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts [1993] OJ L95/29

Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field [1993] OJ L141

Council Directive 94/19/EC of the European Parliament of the Council of 30 May 1994 on deposit-guarantee schemes [1994] OJ L135

Council Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) [2006] OJ L177

Council Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) [2006] OJ L 177

Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L347/1

Council Directive 2010/88/EU of 7 December 2010 amending Directive 2006/112/EC on the common system of value added tax, with regard to the duration of the obligation to respect a minimum standard rate [2010] OJ L326/1

Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) [2008] OJ L177/6

CONVENTIONS AND MODEL LAWS

European Convention 80/934/ECC on the Law Applicable to Contractual Obligations (Rome Convention) [1980] OJ L266/1

New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards [1958]

CONTENTS

TABLES AND FIGURES

CHAPTER ONE: INTRODUCTION

1.1. BACKGROUND: ISLAMIC FINANCE AND THE UNITED KINGDOM

The emergence of the modern Islamic financial industry is recent despite the fact that many of the financial transactions from which it takes its inspiration are of ancient heritage. The revolutionary idea of reviving classical Islamic commercial law in the modern world was first put to practice at an Islamic financial project in Mit Ghamr, Egypt in the 1960s. Thereafter, the first fully-fledged Islamic commercial bank, Dubai Islamic Bank, was established in 1975.[1] Since then the industry's upward trajectory has taken observers by surprise with annual rates of asset growth ranging between 10-15 per cent. The global Islamic financial market, estimated at $951bn,[2] is now active in more than 70 jurisdictions across the globe.[3]

Islamic finance derives many of its principles and rules from classical Islamic commercial law.[4] Although the sharia (Islamic law) does not nor ever has provided the governing order of nation-states throughout the Muslim world,[5] the industry's existence and future development depend, in

---

[1] Askari et al., "*New Issues"* (2009), 5.

[2] International Financial Services London, "Islamic Finance 2010" (2010), 1.

[3] Askari et al., *"New Issues"* (2009), 5.

[4] Following Nicholas HD Foster I use the term "classical" to denote the long period stretching from the first Quranic revelations in 623 A.D. until the early 19th century when Islamic law was displaced by Western-based legal systems. The term "medieval" has been avoided as it refers to a European periodisation.

[5] The sharia was the governing legal order of Islamic empires, kingdoms, and other polities in the pre-modern era, prior to the creation of nation-states. The modern period saw the almost total displacement

large part, on Muslim investors' perception that its financial products and services are in keeping with the rules and religious spirit of the classical Islamic legal tradition.

The fact that the United Kingdom (UK), the principal country on which this research is focused, now constitutes the tenth largest country in terms of the size of its Islamic assets, valued at $10.4 billion in 2008,[6] is an indication of the transnational reach of the industry. In the UK, Islamic finance has benefitted from the City of London's conventional financial prowess. The UK now houses five Islamic financial institutions which offer sharia-compliant financial products and services and the City of London has established itself as the third largest market for Islamic finance after the Gulf Co-operation Council states (GCC) and Malaysia.[7] Moreover, seventeen conventional banks have established windows to offer Islamic financial products and services.[8]

Yet the history of Islamic finance in the UK is fairly recent. In the early 1980s a number of Middle Eastern Islamic banks established subsidiaries in the UK which conducted wholesale operations.[9] In 1982 the first retail Islamic financial operations were developed by the Jeddah-based Al Baraka Investment Company, which bought Hargrave Securities (a licensed deposit-

---

of the sharia as the governing legal order from the Muslim world. For an analysis of the transformation of the sharia see Foster, "Comparative Commercial Law" (2011). One exception is Saudi Arabia in which the sharia is put forth as the law of the land. We discuss this issue further in chapter four, s 4.2.

[6] Askari et al., *"New Issues"*, 7.

[7] International Financial Services London, "Islamic Finance 2010", 1.

[8] The CityUK, "Islamic Finance" (2011).

[9] Wilson, "Islamic Banking" (2010), 212.

taker), and transformed it into an Islamic bank.[10] Following Al Baraka's exit from the Islamic housing market, the United Bank of Kuwait, which had previously focused on Islamic trade financing for Gulf clients, began to offer home ownership plans based on the *murābaḥah* (cost mark-up) contract. These, however, incurred double stamp duty; in the first instance when the property was purchased by the bank and in the second when the property was sold to the client with a profit.[11]

Following the UK government's abolition of double stamp duty in the 2003 Finance Act, these transactions became more competitive with their conventional equivalents and ushered in new business activity.[12] In 2003 HSBC launched its *amānah* current account and home financing products and in 2005 Lloyds TSB also introduced a range of Islamic retail banking products.[13] Not until 2004 did the Financial Services Authority (FSA) license the Islamic Bank of Britain, the first wholly sharia-compliant retail bank in the United Kingdom.[14] Since then four other wholesale Islamic financial institutions (IFIs) have been authorized, including the European Islamic Investment Bank and, most recently, Gatehouse Bank. Moreover, at least nine Islamic fund managers, one sharia-compliant hedge fund manager, a *takaful* insurance provider and a

---

[10] Ibid., 213.

[11] Ibid., 214-15.

[12] Ibid., 217-18.

[13] Ibid.

[14] NS&I, "Review" (2008), 8.

growing number of advisory firms in the legal, accountancy and consultancy professions are active in the UK.[15]

Until recently the United Kingdom was the only country in the European Union to house stand-alone Islamic financial institutions[16] despite its small Muslim population relative to France's seven million and Germany's four million Muslims.[17]

In large part, this is due to the City of London's tradition of innovation and flexibility, its deep and highly liquid markets, and the fact that its exchanges are some of the most frequently used venues for listing and trading financial instruments globally.[18] Furthermore, commercial transactions under English law are protected so as to facilitate free trade and to mitigate the application of rules that would obstruct business activity.[19] The United Kingdom also maintains close linkages with Muslim states and their citizens as a result of its colonial history and subsequent immigration flows.[20]

---

[15] Treasury, "Development" (2008), 6.

[16] HMRC, "Stamp Duty: Response" (2009), 3.

[17] In 2009 Germany licensed its first stand-alone Islamic bank, Kuveyt Türk Beteiligungsbank. See Parker, "Islamic Bank" (2010). In June 2011 Chaabi Bank Europe, a subsidiary of Banque Chaabi du Maroque, introduced the first Islamic retail products to the French market. See Saillon, "Islamic Banking" (2011).

[18] Ainley et al., "Islamic Finance" (2007), 7.

[19] Goode, *"Commercial Law"* (2010), 9.

[20] Nielsen, "*Muslims"* (2004), 40-62.

Furthermore, London's Western pre-eminence is underpinned by multinational participation in the market as evidenced by the fact that Deutsche Bank and Barclays Capital are now among the world's top five issuers of *sukuk* (Islamic bond).[21] Indeed, there are now 20 *sukuk* issues listed on the London Stock Exchange, with total funds of over $11 billion. Only Dubai's NASDAQ exceeds these figures worldwide.[22] Further, money flows through the UK capital via the commodity *murābaḥah* – which are used as interbank short-term lending and syndicated loans – are higher than any other financial centre.[23] Recently, however, other jurisdictions are have been catching up. Luxembourg has worked to amend some of its tax provisions to facilitate its development as an Islamic financial hub[24] and France, Germany and Ireland have begun to initiate tax changes to accommodate Islamic finance within their borders.[25]

1.2 OBJECTIVE

The objective of this thesis is to consider the challenges in formulating and implementing the modern, transnational Law of Islamic Finance (LIF) in conventional financial and legal architectures. It examines the challenges of articulating the LIF from a global perspective since many Islamic financial transactions are cross-border, comprise multiple legal and normative systems, and rely on multiple municipal jurisdictions for their enforcement. Therefore, Islamic

---

[21] Furneaux et al., "Development" (2008/09), 45.

[22] Parker, "Islamic Finance" (2010).

[23] Oakley, "London Leads" (2009), 4.

[24] Parker, "Islamic Finance" (2010).

[25] Masmoudi et al., "Islamic Finance" (2010).

financial transactions, although relying on a local jurisdiction for implementation, are necessarily global in terms of the wide array of factors that influence their composition. The implementation of the LIF, on the other hand, focuses almost exclusively on the United Kingdom; the implementation of the LIF requires a positive municipal legal system and international regulatory order for its effective functioning. However, even the implementation of the LIF cannot easily be limited to a single jurisdiction. Sometimes Islamic financial transactions depend upon multiple jurisdictions for their enforcement, as was the case recently when a default event surrounding a *sukuk* issuance was subject to both English and the United Arab Emirates law of Dubai.[26]

Many subsidiary questions derive from the central research objective. Two general questions are: (1) whether and/or to what extent Islamic financial transactions constitute authentic sharia-based transactions. Sharia-based transactions are those that comply with classical sharia rules and evince the ethical and religious spirit of Islam. On the other hand, sharia-compatible transactions comply with the letter of the law but do not necessarily comprise the law's ethical and religious underpinnings. (2) Whether a truly authentic mode of alternative finance is feasible in the UK, and in Western political economies, in general. This involves the analysis of the institutional arrangements that underlie the economy and political system of Western states; and whether these arrangements permit an alternative mode of finance to co-exist.

---

[26] See Salah, "Debt Crisis" (2010). The Nakheel *sukuk* was did not make it to court so that the the question of which law(s) governed the relevant contracts was not tested.

1.3 TERMINOLOGY

The following terms are used in the following ways:

'Islamic law' and the 'sharia': Literally translated, the sharia is the road to the watering place, the clear path to God.[27] It originates from the primary source of Islamic law, the Quran, which, according to Muslims, is the word of God, revealed by the Prophet Muhammad; and the second revealed source of law, the Sunna, which are the sayings and doings of the Prophet Muhammad. The sharia sets forth numerous comprehensive social obligations and ideals in all facets of life, which, at its greatest extent, encompasses a "totality of life-ways"[28] amongst Muslims everywhere, and attached to these practical consequences and ultimate sanctions.[29] The *fiqh* refers to the body of law created by Muslim jurists and is thus distinguishable from the sharia. In practice, however, the *fiqh* is often included under the umbrella term of "Islamic law", and this practice will be followed herein. The sharia encompasses Islamic commercial law, although classical jurists did not distinguish between commercial and other types of law.

Second, "hybridities" or "hybrid" legal structures: these arise when a range of legal orders interact to create the structure. These legal orders can be located in, for example, state law, religious law or international financial standards in a particular historical context. In this respect hybrid legal structures can be understood as a type of legal pluralism, in that the resulting ordering is based upon a multiplicity of formal and informal, national and transnational legal

---

[27] Ballantyne, *"Essays"* (2000), 33.

[28] Hodgson, "*Venture"* (1961), 75.

[29] Ibid., 74.

sources. Hybrid legal structures are not easily distinguished from “mixed” legal systems. For example, “mixed Law” scholarship does not dispute the legal pluralism of every existing legal system. However, it places greater theoretical emphasis on understanding the interaction of established “families of law” classified according to their historical, geographical and ideological roots, whereas legal pluralism is concerned with all types of normative orderings. Mixed law scholarship also makes initial assumptions concerning its categorisation of legal families as “pure” or “mixed”, etc. Its objective is to locate the elements of legal interaction and try to understand how these elements affect the original legal family.[30]

“Municipal Law”: is the law of a jurisdiction or area in which a legal system is operative, e.g. England and Wales, France and New York state. Terms such as “national law” are defective, as they do not take account of the fact that many nation states such as the UK and the US are divided into various jurisdictions.[31]

The Law of Islamic Finance (LIF): the LIF is the hybrid law of modern Islamic financial transactions practiced worldwide, without specific reference to any particular jurisdiction. It embodies a wide variety of legal norms and systems including the sharia, municipal law, national law, regional law and international regulatory standards. For example, the LIF encompasses the localised versions of the LIF in places such as Malaysia, the UAE, Bahrain and the United Kingdom.

---

[30] See, for example, Örücü, "Mixed” (1996).

[31] Following NHD Foster.

A Municipal Law of Islamic Finance (MLIF): represents all legal aspects of Islamic finance in a specific jurisdiction including the sharia, municipal law, i.e. English law, national regulation (UK law), EU law and international financial standards.

"English Law": is the law of England and Wales. England and Wales, Northern Ireland and Scotland are the three legal jurisdictions that comprise the United Kingdom. Each jurisdiction has a separate judiciary and contains bodies of substantive and procedural law that are applicable only to that jurisdiction.[32] Common law is the basis of the English and Welsh legal system. Wales, Northern Ireland and Scotland have developed constitutional codes for regional governance in the form of devolution statutes. These statutes are: the Northern Ireland Act 1998; the Government of Wales Act 2006; and the Scotland Act 1998. As a result, these three countries have developed distinct legislative and executive institutions that are separate from the central government of the United Kingdom. England has no 'English Parliament' or 'English government' that can be distinguished from the UK as a whole.[33] The UK Parliament, as the supreme legislative body of the United Kingdom, is the sole body with power to enact statutes for England and/or Wales.[34]

---

[32] Feldman, "*Principles"* (2009), 12.

[33] Ibid., 9-10.

[34] Ibid., 101.

“Finance Acts”: are so-called “money bills” which stipulate tax law in the United Kingdom. These Acts are the primary vehicle by which so-called alternative finance arrangements,[35] the term used to refer to Islamic financial transactions, have been facilitated in the UK. Many Islamic financial transactions – throughout the world – are governed by English law.

“Financial Services Authority”: all financial services are regulated by a universal regulatory authority in the United Kingdom known as the Financial Services Authority (FSA). The Financial Services and Markets Act 2000 (FSMA 2000) is the primary legislation that gives the FSA authority to regulate all financial services. The FSA’s regulatory and supervisorial authority is referred to as UK law because of its application in the whole of the United Kingdom.

In the UK the LIF has been facilitated within English law and regulated according to UK financial services law. However, these tiers of legal orders are subject to external legal and normative incursions. For instance, UK financial regulation must comply with European Union (EU) financial directives[36] and the EU has been highly responsive to global financial standard-setting, particularly Basel capital adequacy standards.

Now that the field of legal and regulatory interaction is clarified the following hypothesis is proposed: it is suggested that the challenges of articulating and implementing the sharia in modern financial markets are largely attributable to the application of the law in the complex

---

[35] This is the term used to facilitate Islamic financial transactions in UK Finance Acts.

[36] In chapter six the role of EU financial directives and international banking standards are examined.

modern financial and legal environment. An examination of these challenges illustrates the way in which they transform the sharia into the LIF comprised of hybrid legal elements that, following Foster,[37] represent an emergent legal system in its own right. The financial and legal environment is the primary factor in generating the LIF and its municipal variants (MLIFs). The LIF is a global law, comprised of multiple normative orders, and given municipal effect according to financial imperatives. It is a law that is inspired by classical legal theory and its history of commercial pragmatism. Yet it has been transformed in such a way that it diverges not only from the ethical and religious substance of classical traditions but also from traditional legal forms. The result is a law that has converged with the capitalist world economy but, as a result, has acquired a unique pluralistic and cultural identity. While the LIF has permitted the Islamic financial industry to achieve financial success, theorisers face the central challenge of retaining Islamic authenticity in the law in a highly innovative financial environment. This dilemma is increasingly expressed in terms of whether products and services can transcend the merely sharia-compliant (i.e. permissible, 'ḥalāl') threshold and become sharia-based (i.e. good, 'tayyib').[38]

1.4 SCHOLARLY CONTEXT

The LIF constitutes a very recent field of inquiry amongst Islamic legal and economics scholars. It has generally been presented as a modern enigma, insofar as it combines the utilisation of

---

[37] See Foster, "Islamic Finance" (2007), 186-188.

[38] The classical scale of legal and ethical distinctions is examined in sections 2.2.1 and 3.4.

age-old classical Islamic law with the practices of modern financial markets.[39] The industry's ambitions to create an alternative to the conventional, interest-based financial system and to inject religion, ethics and morality into the substance and conduct of financial affairs strengthen this viewpoint. Thus, the industry's success has rekindled hope that the sharia can again play an important role in the modern world.[40] After its almost total displacement in the mid-19th century, its only viable role has been in the law of personal status, and even this has been transformed in function and form to resemble state law.[41] Some writers have argued that Islamic finance represents the renewal of the sharia in the modern world, although this has proved to be a highly controversial idea.[42]

As a consequence of these larger ramifications, the vast majority of research in the field is devoted to understanding this modern social, legal and economic phenomenon. This thesis does not distinguish itself from earlier works in this regard. Yet it is designed to approach the problem in a different way, by placing emphasis on understanding the law within the regulatory and modern financial environment, rather than seeking answers based on a purely doctrinal legal analysis. A contextual perspective incorporates the fact that commercial law is often forged in reaction and adaptation to dominant market forces, regulation and market events.

---

[39] Karasik et al., "Islamic Finance" (2007), 379.

[40] Vogel and Hayes, *"Islamic Law"* (1998), 3.

[41] Hallaq, *"Sharia"* (2009), 500. Layish, "Secularisation" (1978), 272-73. Anderson, "*Islamic Law"* (1959), 96. Anderson, "*Reform"* (1976), 1-2.

[42] For example, Ray, "Renewal" (1995).

The principal contribution of this thesis lies in its analysis of the pluralistic legal interaction of sharia-compatible financial structures within the UK regulatory and financial services environment. This particular focus clarifies some of the conceptual and practical difficulties surrounding the development of an emergent LIF. Further, it provides insight into the way in which a municipal LIF develops within the institutional framework of specific jurisdictions. Therefore, the thesis clarifies many of the financial practices of the modern Islamic financial industry. This may be important in that the industry's practices have been controversial amongst many devout Muslims. More generally, the thesis argues that the LIF constitutes a unique law in its own right and, as such, would benefit from novel approaches to the topic. The LIF, in fact, may represent the most important part in the renewal of Islamic law in today's world.

To date, scholarly efforts aimed at understanding this complex dynamic have been very few and limited in scope. For example, several articles treat the development in passing, sometimes sporadically, and occasionally by reference to a certain field of study, usually litigation.[43] Others are concerned with charting the development of the industry in the UK.[44] In general, authors' objectives are circumscribed to narrow areas of study; they do not attempt to understand the application of modern Islamic financial law within the context of the nation-state's financial services regulatory architecture. The reasons for this are likely due to the fact that most scholars continue to associate the LIF with classical Islamic commercial law. To the best of my

---

[43] See, e.g. Bälz, "Islamic Finance" (2007); Bälz, "Murabaha" (2004); Bälz, "Islamic Law" (2001); Junius, "Islamic Finance" (2007).

[44] Wilson, "Islamic Investment" (2010); Wilson, "Islamic Banking" (2010); Wilson, "Regulatory Challenges" (2010); Wilson, "Challenges and Opportunities" (2010).

knowledge, only one work has broken free from this constraint and treated the LIF as a law in its own right, comprised of multiple normative and legal systems, and requiring separate study for advancement.[45]

Foster's conception of an emergent legal system represents the first articulation of the LIF as an emerging legal system. His work indicates that the industry's attempt to reduce transaction costs and/or legal uncertainty have led to wide-ranging efforts to create standardised contracts, accounting guidelines and regulatory standards. Further, international Islamic organisations charged with the task represent some of the "normative mechanisms" which are busy creating the LIF. His analysis also considers the role of Western-based law firms in structuring Islamic financial transactions, creating standardised contracts and ensuring certainty by using English law as the governing law of contracts. However, Foster's objective is narrowly circumscribed to providing an outline of the emergent legal system. He does not attempt to articulate the legal pluralistic processes – the interactive tiers of law in tandem with market forces – that effectively generate the LIF.[46]

Another recent contribution is Balala (2011).[47] Balala illustrates how *sukuk* can be integrated into the English common law legal framework. In fact, her work provides insights into the

---

[45] Foster, "Islamic Finance" (2007).

[46] I wish to acknowledge the assistance given by Nicholas Foster (one of my PhD supervisors) in helping me to clarify and develop my thinking with regard to this concept. His perception that the LIF constitutes a separate and emerging legal system has provided the basis of this scholarship.

[47] Balala, *"Theory and Practice"* (2011).

commonalities between Islamic law and English common law that make this symbiosis profitable. However, her principal argument is concerned with showing the fallacy of the sharia's dominant interpretation which stresses a textual form over substance approach to the law. Her work does not consider how the multiple tiers of law in addition to English law, i.e. UK financial services regulation, EU directives, etc., affect the English municipal legal environment.

Similarly, DeLorenzo and McMillen illustrate the means and ways of assimilating Islamic financial structures into a Western-based legal system.[48] However, their objective is not focused on understanding the challenges in articulating and implementing the LIF, rather on demonstrating the necessary legal provisions that must be adopted to facilitate Islamic financial transactions.

A recent book by Aldohni is the first to address the challenges in implementing retail Islamic financial transactions in the UK regulatory and legal environment.[49] His work principally focuses on the implementation of Islamic Home Purchase Plans[50] and refrains from examining the challenges in the articulation of the LIF. Therefore, his work is not an analysis of the way in which the classical sharia is transformed through these challenges. As a result, his analysis does not conceptualise the LIF as the hybrid product of pluralistic legal interaction and competitive financial markets.

---

[48] See, e.g. DeLorenzo and McMillen, "Law" (2007); McMillen, "Sukuk" (2006/2007).

[49] Aldohni, "Islamic Banking" (2011).

[50] Ibid., 162-70.

Legal analyses of the global phenomenon are often concerned with departures or deviations from the erroneously conceptualised classical legal tradition and the resultant economic inefficiencies of the contemporary industry.[51] El-Gamal and Hamoudi are the most prominent authors representing this general line of argument. El-Gamal's work shows great depth and understanding of how the industry practices sharia arbitrage, i.e. fulfilling the legal dictates of the sharia but evading the religious substance of its provisions. Likewise, Hamoudi demonstrates an almost visceral disdain for the legal fictions which he claims characterise the industry. Strangely, neither author considers whether the classical commercial tradition was any different. Nevertheless, both authors convincingly demonstrate that, in practice, Islamic finance pays much too little attention to the ethical and moral substance of the law. These authors do not consider the challenges in the implementation of the law, and, as a result, are not concerned with the sharia's pluralistic legal interaction within municipal legal systems. Nor do their analyses view the LIF as an emergent legal system. Their objectives have clear consequences for how they perceive the law that comprises the Islamic financial industry.

Moreover, underlying El-Gamal's and Hamoudi's general premise is the intimation that Islam must rethink its prohibition of lending at interest for Islam to play a meaningful and authentic role

---

[51] See, e.g. Hamoudi, "Schizophrenia" (2006-2007), 611; Hamoudi, "Muezzin's Call" (2008); Hamoudi, "Social Justice" (2007), 112; Hamoudi, "Revolution" (2007-2008), 262; El-Gamal, "Interest" (2003-2004); El-Gamal, "*Islamic Finance*" (2006).

in the modern economy.[52] However, this suggestion is not feasible – nor has it ever been – amongst devout Muslims. It would require Muslims to turn their back on a prohibition that pre-dates the rise of Islam.[53]

A number of other authors[54] have undertaken rigorous analyses of the LIF that offer insightful views on the modern law. However, these works are not concerned with the interaction of market forces and multiple tiers of law. The line of reasoning in these works assumes that sharia scholars' development of the law is the result of a strict ethical adherence to the *uṣūl al-fiqh* (principles of jurisprudence). Their work rarely problematises jurists' legal rulings (fatwas). Their interpretation of the LIF is generally explained by jurists' extraction of the law from the holy sources. Our analysis of the LIF demonstrates that multiple tiers of legality and market forces are the principal normative mechanisms behind the LIF, which distinguishes it from classical jurisprudence.

---

[52]For example, El-Gamal argues that ribā should be interpreted in terms of efficiency rather than exploitation. He argues that Ibn Rushd perceived this underlying meaning long ago. Such an interpretation would force jurists to rethink whether the absolute prohibition of interest is, in fact, contrary to the more limited meaning. El-Gamal, "An Economic Explication" (2001). See supra note 26 for Hamoudi's references to the prohibition of *ribā*.

[53] For a discussion of pre-Islamic ideas concerning usury, see Langholm, "*Aristotelian Analysis"* (1984).

[54] See, e.g. Vogel and Hayes, *"Islamic Law"*; Kamali, "*Commercial Law* " (2000); Ray, *"Renewal"*

The majority of the vast body of Islamic financial literature represents textbook-like introductions of the main financial developments in the field and the prevalent legal structures employed.[55] Most of the works in this genre are quite descriptive. These works are not legal approaches to the LIF, although they do invariably outline the financial structures used in the industry. Many of these works are very informative and thus contribute to the informational requirements of the industry, but they are not concerned with the interactive nature of the law nor its nature as an emergent legal system.

A small number of insightful and thoroughly interdisciplinary analyses of the field shed light on the sociological, legal and economic importance of Islamic finance[56] but in so doing underemphasise or fail to address the complex history and primary role of the law which undergirds Islamic financial transactions. In particular, Warde offers one of the best all-around analyses of modern Islamic finance. The great strength of his work is that it emphasises the importance of understanding the financial environment in which Islamic finance operates. Moreover, his general premise that the overriding influence of economic forces determines the trajectory of the industry accords with the results of this research. Yet his work portrays a global industry in broad brushstrokes, so his analysis sometimes neglects the nuances and contextual

---

[55] Thomas and et al., "Structuring" (2005); Visser, *Islamic Finance* (2007); Kettel, "*Introduction"* (2008); Saw et al., "*Introduction"* (2008); Saw et al. "*Theory and Practice"* (2008); Ahmad, "*Theory and Practice"* (2010). El Diwany, "*Islamic Banking"* (2010).

[56] Warde, "*Islamic Finance"* (2000); Maurer, "*Mutual Life"* (2005). Abdul-Rahman has produced an interesting work in which he tries to understand the modern role of money and its effects on Islamic finance. Abdul-Rahman, "*The Art"* (2010).

richness that a focused case study presents. For example, Warde devotes a significant portion of his work to the analysis of the Islamic financial landscape and the emergence of IFIs in global financial markets. Yet his book devotes only a small chapter to the role of global financial regulation, and then does so by generalising regulatory mandates as though they were not connected to municipal jurisdictions.[57]

Maurer's anthropological perspective of the industry helps us to understand the sociological importance of Islamic finance's highly "entangled" social and economic practices. Thus, his book helps to clarify the complex social meaning surrounding the emergence of Islamic finance. However, his work underplays the central importance of the sharia with respect to Muslims' choice to believe and invest in Islamic financial products.

1.5 GENERAL METHODOLOGY

The approach to researching this thesis has been primarily literature-based. The literature on classical Islamic law and Islamic legal theory consists primarily of secondary sources, but a few translated primary works were also used. It was felt that the predominance of secondary sources did not diminish the authority of the research, as its primary function was to create a general picture of the field of investigation. Research connected to the municipal LIF – the case study of the UK's localised facilitation of Islamic finance – employed government documents and

[57] See ch. 10 on regulatory issues.

miscellaneous communications originating from Islamic finance conferences as well as private, informal conversations. This general approach was conducive to the objective of researching the law's articulation and the challenges of its implementation. For example, the interaction of the LIF with municipal, national and international legal systems required the use of government documents and non-governmental sources of information. The research also called for utilising a number of English court judgments that pertain to the enforcement of Islamic financial transactions.

The formulation of the LIF and its implementation in the UK involve a study of the interaction between several legal systems. It was necessary to use the comparative law methodology and, in particular, legal pluralism. Various aspects of the thesis have also benefitted from work on legal transplants.

1.5.1 COMPARATIVE LAW

Comparative law compares and contrasts trends, similarities and dissimilarities of norms, institutions, cultures and entire legal systems.[58] It "affords us a glimpse into the form and formation of legal institutions which develop in parallel, possibly in accordance with laws yet to be determined, and permits us to catch sight, through the differences in detail, of the grand

[58] Palmer, "Lerotholi" (2005), 262-63.

similarities […]" as well as the mutual influence between legal systems.[59] Furthermore, comparative legal tools help us to understand particular factors shaping legal growth and change. It helps us to understand better the nature of law and especially the nature of legal development. This is often achieved by examining the historical relationships between legal systems.[60]

Comparative law offers a number of methodologies that help to achieve these goals. These include the historical, evolutionary, functional, statistical and empirical methods but could include any number of comparative legal techniques.[61]

An important tool for understanding the implementation of the LIF in the UK concerns the concept of legal transplants. The concept refers to the process of a rule relocating "from one country to another or from one people to another".[62] Once relocated, a legal transplant often develops within the host system just as a native rule or institution would. Legal transplants generally fall into three categories, despite their wide variety of shapes and sizes: (1) when a people relocates to a foreign country where there is a much different civilisation, and brings its law with it; (2) when a people relocates to a foreign country where there is a similar civilisation but, nonetheless, brings its law with it; (3) and "when a people voluntarily accepts a large part of

---

[59] Zweigert and Koetz, "*Comparative Law*" (1998), 3.

[60] Watson, "*Transplants"* (1993), 7. See generally Twining's categorisation in "Globalisation" (2000).

[61] Palmer, "Lerotholi" (2005), 263.

[62] Watson, "*Transplants"* (1993), 21.

the system of another people or peoples".[63] The concept of legal transplants assists in conceptualising the process by which the LIF has been transmitted to the UK via immigration flows, historical ties and commercial relationships.

The concept of legal pluralism advances this analysis significantly by providing a framework for understanding the transformation of the sharia in its interaction with multiple legal and normative orders in a single jurisdiction. Legal pluralism describes a situation in which two or more bodies of law coexist in the same social field.[64] The concept originated from studies of hybrid legal systems created by European colonisation. European countries superimposed their state-based law on native legal systems, resulting in a situation in which different bodies of law were available for different population groups.[65]

From the 1970s, the concept has been used to analyse non-colonised industrial states. In this context it is used to examine relations between dominant and subordinate groups, such as ethnic, cultural and religious minorities, as well as unofficial normative orders[66] in institutional

---

[63] Ibid., 29-30.

[64] Woodman, "Pluralism" (1999), 10.

[65] Merry, "Pluralism" (1988), 870.

[66] The boundary between normative orders that can and cannot be called law has not been decided and will not be attempted in this thesis. The problem persists because of the great diversity amongst normative orders and the particular social fields in which they are present. The normative orderings examined in this thesis are relatively uncontroversial in that Islamic law is generally accepted as 'law', and other legal systems are either state-based or globally accepted as normative standards, i.e. Basel Capital Adequacy Requirements (CARs).

and social networks.[67] Contemporary views of legal pluralism see the interaction of highly complex normative orders in virtually every society and social field. As a result, legal pluralism's early focus on the effect that law had on society, and vice versa, has been redirected towards the interaction of highly complex official and unofficial normative orders in the same social field.[68]

A useful tool in this regard is the concept of semi-autonomous spaces, which is a methodological tool used to describe the pluralistic ordering of complex societies.[69] The concept provides the powerful insight that the "semiautonomous social field is one that can generate rules and customs and symbols internally, but that [...] is also vulnerable to rules and decisions, and other forces emanating from the larger world by which it is surrounded".[70] The concept introduces a realistic conception of social fields that are not confined by impermeable boundaries and in which local, national, and global normative orders interact with each other simultaneously. Crucially, cultures or social orders are never impervious or sealed-off from outside forces; instead they are dynamically evolving sub-systems which interact with other referents in highly complex ways;[71] and which may come to mimic, resemble or define themselves in opposition to each other.

---

[67] Merry, "Pluralism" (1988), 872.

[68] Ibid., 873.

[69] The methodology is attributable to Moore, "*Law*" (1978).

[70] Merry, "Pluralism" (1988), 878.

[71] Twining, "*Globalisation*" (2000), 85.

Thus the concept of semi-autonomous spaces is an important tool in recognising the plurality of state law. "State law legal pluralism" has been described as a type of legal pluralism in which multiple bodies of law within the state are branches of a much larger body of norms.[72] State law "constitutes and is constituted by the normative orders of which it is composed",[73] whether these derive from customs, religion, religious law, corporations, institutions, associations or states.[74] Therefore, state law represents a plurality of legal norms, sometimes conflicting and otherwise fused in disparate networks of legalities. This post-modern conception of the law, which differentiates it from positivist views that isolate state-based law as a separate field of study,[75] highlights the "multiple networks of legal orders" that intersect in dynamic, unstable[76] and generative ways.

The multiple tiers of law evidenced in our case study of the UK reflect this complex reality of interacting values, norms and legal systems.[77] Hence, the sharia, English law, UK law, EU law, and international financial standards interact in ways that sometimes interfere with one another,[78] or have unforeseen outcomes. The result of this conception prevents the examination of a single normative or legal system in isolation from others without underestimating the complexity of the legal system in consideration.

---

[72] Woodman, "Pluralism" (1988) 10.

[73] Merry, "Pluralism" (1988), 883.

[74] Örücü, "Mixed" (1996), 342.

[75] Menski, "*Comparative Law*" (2006), 55.

[76] Santos, "Law" (1987), 298.

[77] Santos, "*Sense*" (1995), 270.

[78] Ibid.

Furthermore, a state's facilitation of normative orders within its legal framework may create and give legitimacy to a plurality of normative orders. The facilitation of Islamic financial transactions within English law is a case in point. This facilitation provides individuals with the freedom to realise their own financial objectives within a framework specified by municipal law. Similar to the legal facilities of the marriage, contracts, wills, companies and trusts, the government has enabled individuals' private law-making;[79] in this case, their ability to determine their legal relations with others in accordance with their religious beliefs. The result of these facilitations, to varying degrees, creates and legitimates a "plurality of semi-autonomous realms" within the state.[80] The state's incorporation of these realms may give an illusion of a single ultimate source of authority, a unitary legal order,[81] which does not necessarily apply.

Legal pluralism represents a conceptual shift "away from the ideology of legal centralism" – the doctrine that holds all law is made by the state.[82] It throws into question whether other semi-autonomous legal and normative systems should be recognised and accommodated. The marginalisation of pluralistic normative systems may undermine efforts to establish social harmony and impartial justice.[83] Worldwide, normative pluralities are in the process of de- and re-territorialising social, legal and financial relations in former colonial empires. This is evident

---

[79] Sugarman, "Law" (1983), 216.

[80] Ibid.

[81] Goldberg and Attwooll, "Legal Orders" (1996), 320.

[82] Merry, "Pluralism", (1988), 889.

[83] Menski, "*Comparative Law"* (2006), 64.

in the transmission of the LIF to the United Kingdom. In this historical context the transmission and interaction of culturally diffuse norms has resulted in hybridities or hybrid legal structures.[84]

However, recognising the plurality of normative and legal systems does not go far enough. Legal pluralist analyses are useful in their capacity to situate the interaction of pluralistic normative orderings in a particular historical context. This may assist policymakers and practitioners to accommodate non-state based legal systems in a manner that reflects the moral conditions of localised social life. By providing analyses of normative orderings in particular historical locations, legal pluralist analyses build a bridge to the social conditions in which legal norms and values are formed and expressed, and from whence their authority and legitimacy derive.[85]

1.6 STRUCTURE

The following discussion summarises the content and highlights the role of each individual chapter. In particular, it illustrates the way in which each individual chapter contributes to answering the principal research objective. Apart from this chapter the thesis consists of 3 parts, formed of 9 substantive chapters and a conclusion.

---

[84] Geertz, "*Local Knowledge*" (1983), 216.

[85] Cotterrell, "*Law's Community*" (1995), 3.

1.6.1 COMMERCIAL LAW IN THE CLASSICAL SHARIA

Part I consists of chapters two and three. It provides a general outline of the sharia and classical Islamic commercial law, and some general trends in the classical practice of Islamic commerce.

Chapter two concerns the sharia in general, its sources, its legal theory and the role of *ijtihād* (independent reasoning) in solving new legal problems. It also contains a discussion of custom as an unofficial source of law. Finally, the chapter discusses the important role of rationalising legal tools and legal stratagems (*ḥiyal*).

Chapter three provides an analysis of Islamic commercial law. The chapter examines the system of Islamic nominate contracts; the prohibitions of *gharar* (excessive uncertainty) and *ribā* (interest); and the way in which classical Islamic commerce was practiced, with particular emphases on the role of custom and on credit- and interest-based transactions.

1.6.2 THE CHALLENGES OF FORMULATING A MODERN LAW OF ISLAMIC FINANCE

Part II consists of chapters four and five. It examines the challenges in formulating the LIF in modern financial and legal environments.

Chapter four provides a bridge from the previous chapters' focus on classical Islamic law and commercial practice to the modern global economy. It illustrates some of the economic challenges affecting the world economy and how Islamic financial theorisers have responded to these in their articulation of the LIF. It illustrates how the changing role of money has radically restructured social, legal and economic interaction. It also considers the almost total displacement of the sharia in the modern era as well as subsequent social and legal efforts to revive a part of it via interest-free banking. Finally, the chapter examines the strategy of Islamic financial *ijtihād* in responding to these challenges.

Chapter five highlights the strategies and tools employed in adapting classical contracts via Islamic financial *ijtihād* to modern financial markets by looking at its products, including the *murābaḥah, tawarruq* and *sukuk* issuance (Islamic bond). The chapter examines the differences between conventional and Islamic products, the legal problems associated with these structures and their dependence on how the courts of a particular jurisdiction will enforce them. As a case study of the set of legal problems which can arise, an analysis is presented of the juristic ramifications of a recent statement issued by the Accounting and Auditing Organisation for Islamic Finance (AAOIFI) on *sukuk*.[86]

---

[86] The highly respected Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1991 to create standards on accounting, auditing, and governance.

1.6.3 THE CHALLENGES OF IMPLEMENTING THE LAW OF ISLAMIC FINANCE

Part III consists of chapters six, seven, eight and nine. It examines the complex challenges in implementing the LIF. It demonstrates the complexity of facilitating and regulating Islamic finance in a modern legal and financial environment such as the United Kingdom. This part shows that the municipal LIF which results from this process is a hybrid legal order generated from the interaction of multiple legal elements and underlying market forces.

Chapter six examines how and why the LIF has been facilitated legislatively within English law. The chapter shows the particular type of legislative accommodation given to the LIF, with a special emphasis upon the development of commercial and sovereign *sukuk.* The challenges of creating an authentic sharia-based mode of finance are considered.

Chapter seven looks at the rationale, the objectives and the tools with which UK regulators regulate IFIs. The chapter introduces the reader to the UK financial services regulatory environment, examines financial services regulation, EU financial regulation and international regulatory standards. The chapter shows that Islamic finance interacts with a complex set of regulatory norms and legal systems, and this interaction directly affects the types of financial structures the industry can competitively employ.

Chapter eight examines the particular risks of Islamic financial intermediation and the FSA's response to regulating IFIs, including sharia supervisory boards (SSBs). The chapter illustrates

a number of ways in which the state's regulatory norms may interfere with Islamic financial intermediation. A particularly important aspect covered by the chapter concerns the FSA's approach toward regulating the law-making capacity of SSBs.

Chapter nine illustrates the challenges incumbent upon contracting parties wishing to have their contract enforced according to the sharia in an English court. The chapter does this by addressing several important cases in which Islamic financial transactions were the focus of litigation. Furthermore, the chapter investigates the role of arbitration as an alternative means of resolving Islamic financial disputes.

Finally, the Conclusion addresses the thematic problems illustrated by the thesis and offers proposals for their resolution. It draws out the main implications for the further development of the LIF on the basis of these proposals. The importance of future research in building upon the the findings from this thesis is given consideration as is its general appeal.

1.7 TECHNICAL MATTERS

Dates used throughout the thesis correspond with the Gregorian calendar, although effort has been given to providing the Islamic calendar, where appropriate. References to the "classical" period indicate the large time span beginning with the inception of Islam and continuing until the "modern" period in the 19th century.

The Library of Congress transliteration standard has been used to transliterate Arabic words and names into the Roman script. Most Arabic words in the singular form have been given an English 's' to denote the plural. Words such as *sukuk*, however, which are often used in financial markets, are used exclusively in the plural. Finally, Arabic words that have been borrowed into the English language by the Oxford English Dictionary have been used according to the way in which that publication stipulates usage. Such words include the sharia, Hadith, Sunna, ulema and others.

A simple referencing system has been used. All case law references, statutes, EU legislation and conventions are located in the preface of the thesis. All books, articles, chapters, documents and websites can be found in the bibliography, located in the appendix. These latter references have not been classified according to genre so as to facilitate the reader in locating the relevant work.

Finally, a considerable number of abbreviations have been used to simplify the language of the text. Please refer to the list of abbreviations on page 5.

PART I: COMMERCIAL LAW IN THE CLASSICAL SHARIA

CHAPTER TWO: THE SHARIA: SOURCES, LEGAL THEORY, AND UNOFFICIAL SOURCES OF LAW

INTRODUCTION

This chapter provides the background to the discussion of chapter three in which classical Islamic commercial law is examined. It contains a discussion of the sharia, its sources and legal theory, the role of custom, "rationalising legal principles" and legal stratagems known as *ḥiyal*. It examines the historical development of the four formal sources of the sharia according to Sunni Islam and its ensuing legal theory. It is argued that the sharia, despite its rigorous textual hermeneutic, is an adaptive, pragmatic and functional law that possesses a number of legal instruments, which enable jurists to adapt the law to changing needs and circumstances. These premises are demonstrated by examining the following topics in turn: the formal sources of the sharia; Islamic legal theory (*uṣūl al-fiqh*); the role of custom and rationalising legal principles; and the role of *ḥiyal.*

2.1 THE FORMAL SOURCES OF ISLAMIC LAW

Four formal 'sources' underlie the body of Islamic jurisprudence. These include the Holy Quran and the Sunna, which constitute the wellspring of Islamic jurisprudence. The third and fourth sources are *qiyās* (analogical reasoning) and *ijmā'* (scholarly consensus), which jurists used to develop the nascent law.

The Quran is the first and most sacred source of legal and moral guidance to the Muslim faithful. It contains revelations to the Prophet Muhammad, believed to have emanated directly from God. These were embodied in permanent written form in the Quran shortly after the death of Muhammad in 632 CE. The Quran is concerned with a broad range of circumstances in the believer's life, which extend from matters of prayer, ritual and belief to the family, transactions and/or commerce, criminal acts and much more. Unlike secular legal systems the Quran does not differentiate between law and morality but sees the two as inextricably linked; in fact, one cannot possibly exist without the other.[87]

It is generally accepted that Islamic law, envisioned as a system of rules and standards which impose order and sanction malfeasance, existed outside the sphere of religion, even during the Prophet's lifetime. As far as there were no religious or moral objections to specific transactions or modes of behaviour, Muslims remained largely indifferent to the more technical and purely legal aspects of the law.[88] Muhammad may have only realised in the fifth year of the *Hijra* – after the migration to Medina – that his revelations also contained legal matter of significant import for the community.[89] Indeed, it is generally agreed that the Quran itself contains

---

[87] Bergsträsser, "Anfänge" (1925), 78.

[88] Schacht, "Pre-Islamic" (1955), 35. While Schacht argues that law did not exist in the technical meaning of the term, he omits the fact that pre-Islamic customary practices were, in essence, nothing other than law.

[89] Goitein, "Birth-Hour" (1960), 27.

relatively few technical legal verses that Muslim jurists were able to readily apply as the foundation for a growing body of Islamic law.[90]

The early jurists of the Umayyad dynasty did not have a polished and ready “Islamic law” at their disposal from which legal rulings could be taken. Foreign and pre-Islamic Arab customary practices constituted the raw material of the budding law which the religious specialists and caliphs of Islam shaped according to their discretion (*ra’y*) or “sound opinion”, as it was called, and with respect to the unique practices or customs of the jurisdiction in which the law was to be applied.[91] In large part, the early law did not derive from the Quran. Apart from areas of family law and inheritance, as well as cult and ritual, the norms taken from the Quran were reintroduced to the law during the second/eighth century.[92]

Early jurists adhered to the ancient Sunna of their ancestors, and later to the ‘living tradition’ of their respective schools.[93] The Sunna (pl. *sunan*), an ancient Arab concept, describes an

---

[90] Schacht, "Fiḳh." (2011).

[91] The raw material from which Islamic law originated was comprised of a wide range of foreign and pre-Islamic borrowings including Mesopotamia, Judaism, Christianity, the Hellenistic and Roman civilisations, and. See Schacht, "Foreign” (1950), and Schacht, "Babylonian” (1994). For a critical examination of these influences as well as an assessment of Western-based research on the subject see Crone, “*Roman”* (1987). See also Vesey-Fitzgerald, “Alleged Debt” (1951). For an analysis of common legal institutions, language and stylistic patterns in Middle Eastern legal texts see Mallat, "From Islamic” (2003), 704.

[92] Schacht, "Pre-Islamic” (1955), 41-42.

[93] *Madhhab* is conventionally translated as school or doctrine. It usually refers to a jurist’s opinion concerning a particular case or to the opinion of an entire school. See Melchert, "Formation” (2004).

exemplary mode of conduct that is meant for others to emulate. Persons renowned for their charisma, rectitude and distinguished status in the pre-Islamic period were seen as the providers of Sunna or normative practices that should be followed.[94] Adherence to traditional Sunna constituted the ethical, social and religious framework around which Arabian life revolved and found its meaning.[95]

Much of the material comprising prophetic Hadith was derived from the ancient Sunna and *ra'y*. Prophetic Hadith were endowed with a legitimacy, however, that these sources of law did not possess.[96] In fact, many of the Hadiths put into circulation were blatant fabrications. They reflected the ideal wishes of the present and were projected back to the Prophet so as to endow them with authority.[97] Jurists faced the difficulty of establishing the connection between a text and the Prophet. The discovery of dubious personages or a defective chain of transmission (*isnād*) rendered Hadiths devoid of any legal effect. Furthermore, Hadiths were scrutinised for their linguistic traits as well as their chain of transmission before they could be utilised as valid sources of legal reasoning.[98]

Sunni Islam is composed of four doctrines or schools of law (pl. *madhāhib*) which bear the name of distinguished jurists associated with them: the Ḥanafī, Mālikī , Shafi'i and Ḥanbalī schools. Other Islamic sects include the Shia, which are predominantly represented in today's Iran and large parts of Iraq. The Shia comprise three schools including the Zaydīs, the Twelvers (Jaafaris) and the Ismāʿīlīs.

[94] Hallaq, *"Sharia"* (2010), 40.

[95] Schacht, "Pre-Islamic" (1955), 34-35.

[96] Hallaq, *"Sharia"* (2010), 45.

[97] Goldziher, "Muhammedanisches" (1888), 418.

[98] Hallaq, *"Sharia"* (2010), 92.

The uncertainty surrounding a Hadith's origins led jurists to devise the requirement of multiple transmission or recurrence known as the principle of *tawātur.* Islamic theology views the recurrent transmission of texts from multiple sources as a type of knowledge that is immediate, subconscious and innate.[99] On the other hand, texts transmitted via channels fewer than that of *tawātur* are termed *aḥad* (solitary). The vast majority of Hadith belong to this latter category, which Muslim theologians generally view as a source of probable knowledge. The important point is that the large body of Islamic law – which largely derives from Hadith narratives – reflects a *probable* interpretation of God's commands.[100]

The epistemic importance of prophetic Hadith, the great authority and legitimacy that such narratives inspired, is probably the reason why the prophetic Sunna gradually eclipsed the authority of ancient Arab practices. Prophetic Hadith were endowed with a unique legitimacy that allowed jurists to shed light on what the law was.[101] Jurists eventually came to realise that the prophetic Sunna comprised an important aspect of Quranic hermeneutics; it gave them clues as to the meaning of the Quran with respect to a particular case. [102] It enabled the construction of a body of Islamic law known as *fiqh*.

The great jurist and systematiser of the law, al-Shāfiʿī (d. 204/820), is considered to be the originator of the theory of Sunna – the endowment of *Sunnaic* authority in the Prophet

---

[99] Ibid., 93.

[100] Ibid.

[101] Ibid., 41.

[102] Ibid.

Muhammad - in classical Islamic law.[103] Al-Shāfiʿī considered *ra'y* to be an arbitrary form of reasoning that threatened to taint the holy texts with human judgment.[104] His unerring insistence upon the sole authority of traditions originating directly from the Prophet, and his dismissal of 'practice' and 'consensus' as embodied in the living Sunna eventually established prophetic Hadith as the second exclusive source of law.[105] The authoritative establishment of prophetic Hadith allowed religious scholars less freedom to exercise their juridical discretion (*ra'y*). Al-Shāfiʿī had achieved a means of conformity in the law that would help to preserve it from human meddling.[106] The eventual triumph of Hadith over *ra'y* towards the middle of the third/ninth century saw the emergence of six "canonical" Hadith collections.

Long before non-textual *ra'y* was outlawed, however, jurists had foreseen the great value of certain types of reasoning that were too important to discard. In a long process that stretched from the middle of the second/eighth century and continued well into the next, the concept of *ra'y* underwent a largely semantic transformation that established several different categories of legal tools that derived from the same principle. These were *qiyās*, *ijtihād* and *istiḥsān*. *Qiyās* signified a disciplined form of reasoning that was rooted in the holy texts, i.e. the Quran and Sunna. Its primary typology is analogy although it also includes the *a foriori* argument in both of its forms, namely the *a maiore ad minus* and the *a minore ad maius*.[107] The textual authority for

---

[103] Schacht, "*Origins"* (1950), 77.

[104] Hallaq, *"Sharia"* (2010), 51. See also Schacht, "*Origins"* (1950), 20.

[105] Schacht, "*Origins"* (1950), 20.

[106] Hallaq, *"Sharia"* (2010), 49.

[107] Ibid., 50.

qiyās was found in prophetic Sunna and the practice of the Companions.[108] Eventually, *qiyās* came to be accepted as the fourth formal source of law.

Of the three categories *ijtihād* represented the most general type of reasoning. Prior to the disapproval of *ra'y* it had been known as *ijtihād al-ra'y*. Sometime in the 2nd/8th century the *ra'y* was dropped – it had become untenable - but the concept retained the same meaning, namely: "the total expenditure of effort in the search for an opinion as to any legal rule in such a manner that the individual senses (within himself) an inability to expend further effort".[109]

The third category, *istiḥsān,* represents a mode of reasoning that overrides strictly logical inferences derived from *qiyās,* which may present undue hardship. A more reasonable, preferred solution may be chosen in its stead. Therefore, *istiḥsān* appeals to a general sense of fairness, conscience and common sense.[110] However, it lacked any textual authority and was the subject of much criticism. Its usefulness clearly outweighed such criticism in the end, however, and consequently was adopted by the Ḥanafī, Mālikī and Ḥanbalī schools, while Shāfiʿī jurists rejected it altogether.[111] The principle of *istiḥsān* was lent considerable weight by allowing the jurist to reject *qiyās* in favour of *istiḥsān*, in response to the flexibility it provided.[112] Citing Al-Shaybānī, Al-Sarakshi wrote that "*[I]stihsan* is the renunciation of analogy and the

---

[108] Ibid., 80.

[109] Weiss, "Interpretation" (1978), 207.

[110] Kamali, "*Principles"* (2003), 323.

[111] Hallaq, *"Sharia"* (2010), 50. See also Kamali, "Principles" (2003), 324.

[112] Hallaq, "*Theories*" (1997), 109.

adoption of what is more fitting for people. Some say: *istiḥsān* seeks to introduce more lenience in laws in connection with difficulties encountered by the individual and the general public (viz., everyone). Some say: it is to give wide latitude and to solicit comfort".[113]

Therefore, the strict textual adherence demanded by the proponents of prophetic Hadith was not complete and unconditional. In fact, by the end of the third/ninth century jurists are reported to have arrived at a "great synthesis", a methodological recognition that combined the different approaches to the law.[114]

The third formal source of Islamic law is known as consensus *(ijmā').* Consensus provided jurists with an all-important juristic tool for safeguarding the entire structure of the law, including the individual opinions (fatwas) of jurists that formed a body of Islamic jurisprudence (*fiqh*).[115] It can be defined as "the agreement of the community as represented by its highly learned jurists living in a particular age or generation".[116] The concept establishes the epistemological certainty of any particular law based upon probable textual evidence and agreed upon by the *mujtahids* (the highest class of jurists). In fact, once consensus was agreed on any particular point of law it became "an infallible expression of the divine law" and could not be cast aside by any future *mujtahid*.[117] As a result, the law was divided into two spheres, namely that in which

---

[113] Libson, "Custom" (1997), 151.

[114] Hallaq, *"Sharia"* (2010), 56.

[115] Ibid., 100.

[116] Hallaq*,"Introduction"* (2009), 21.

[117] Weiss, *"Spirit"* (1998), 122.

unity prevails (*mujmaʿ ʿalayh*) and that in which there is disagreement (*mukhtalaf fīh*). Within the sphere of disagreement diversity in the law is given free reign so that the schools of law and their body of doctrine can be justified as equally valid representations of the law.[118]

Like all sources of law, with the exception of the Quran whose divine origins are grounded in a broad consensus that pre-dates the juristic notion of *ijmāʿ*, authority for *ijmāʿ* as a source of law had to be found in the revealed texts. While fatwas evince probable knowledge, the sources of law – which uphold the faith – must be absolutely certain. However, the Quran did not have a lot to offer in this regard. Therefore, around the end of the third/ninth century a Hadith was promulgated that established, once and for all, that Muhammad's community (*umma*) as a whole could never agree upon an error.[119] Needless to say, the textual proof (Sunna) that legitimised consensus as a source of law had itself only recently attained certitude.[120]

Consensus can only be established on the basis of revelation and with respect to a textual indicant (*dalīl*). Importantly, consensus from the past must be assumed to have located the textual indicant whether or not the present generation has discovered it.[121] Once consensus has been established it may act as a driver of further *ijtihād.* As *ijtihād* yields new law, consensus can continue the process of law-making by enshrining the law to the realm of God.

---

[118] Ibid.

[119] Hallaq, *"Sharia"* (2010), 80.

[120] Ibid.

[121] Hallaq, *"Theories"* (1997), 76.

Hence, consensus has been likened to the common law concept of *stare decisis* or doctrine of precedent, although its formulation does not take place in the courtroom.[122]

The absolute certainty bestowed by consensus, coupled with the authority it derives from the revealed texts, endows consensus with a superior authority over the Sunna and the Quran. Essentially this means that whenever consensus has been established with respect to a particular matter, the textual evidence used to arrive at a consensus trumps any other conflicting evidence. The reasoning behind this is circular. Evidence set aside as a result of consensus is deemed irrelevant insofar as the community of Muslims would not have agreed on other evidential indications.[123]

The development of the *fiqh* was gradual and marked by great debate and decisive theological developments. A clearly delineated set of legal sources grew out of this process, as well as a number of legal tools used to provide flexibility. In the following section the legal theory of Islamic law is examined.

---

[122] Weiss, "Interpretation" (1978), 208-09.

[123] Hallaq, *"Theories"* (1997), 76-77.

2.2 THE THEORY OF ISLAMIC LAW

The substantive body of Islamic jurisprudence known as *fiqh* was developed prior to the *uṣūl al-fiqh*, the legal theory that is rooted in the four sources of Islamic law.[124] Moreover, the *fiqh* that had developed by the end of the 2nd/8th century was not modified as a result of the genesis of the new legal methodology. Rather the creation of the *uṣūl al-fiqh* seemed to mark a culmination in how the law should be developed but it also sought to endow the law with an ideal character.[125] From around the middle of the fourth/tenth century, however, the *uṣūl* adopted a more prescriptive nature, while maintaining its normative and descriptive functions.[126]

The theory of *uṣūl al-fiqh* required jurists to know which cases were subject to consensus so as not to work outside of existing school doctrine or the larger community of jurists. Cases not subject to consensus – those having remained subject to disagreement (*ikhtilāf*) – or novel legal problems were subject to the theory.[127] *Qiyās* was to provide the legal tool that was to elicit new law. It comprised four elements: (1) the novel case requiring a legal solution; (2) the established rule, which can be found in the revealed texts or amongst those established by consensus; (3) the *ratio legis (ʿillah)*, also known as the "effective cause", which can be found in both of the aforementioned cases; (4) the legal norm found in the established case, which, on the basis of

---

[124] This research is limited to an investigation of Sunni Islam and its four formal sources.

[125] Hallaq, *"Sharia"* (2010), 74.

[126] Ibid., 75.

[127] Ibid., 100-01.

similarity between the two cases, can be transposed to the novel legal problem.[128] Consequently, the determination of the *'illah* became the jurist's principal task. Some *'illahs* were quite explicit and thus easily deciphered, while most could only be gleaned from inference and interpretation.[129]

The *uṣūl al-fiqh* created a juristic modus operandi by which the Muslim jurist was to exercise his *ijtihād.* In fact, the practice of *ijtihād* was seen as a divine communal obligation (*farḍ kifāyah*) that all jurists had to perform as a means of worship and belief in God.[130] It was to proceed in the following manner: first, earlier legal opinions of renowned jurists were examined so as to determine whether a similar ruling already existed. Second, when no precedent was available, other cases could be resorted to in which legal acts were of a different nature but essentially involved the same legal facts. Third, when all else failed the jurist could consult the Quran, *Sunna* or *ijmā'* to locate an *'illah* that is compatible with the new case (*furū'*). This was accomplished with the aid of *qiyās*.[131]

2.2.1 THE EPISTEMOLOGY OF ACTS

The process of *ijtihād* highlights the probable nature of the jurist's *fatwa*. It is a central epistemic challenge that was solved by viewing the law bi-dimensionally: namely, via the (1) the forum

---

[128] Ibid., 101.

[129] Ibid.

[130] Hallaq, "the Gate" (1984), 5.

[131] Ibid.

internum or religious conscience; and (2) the *forum externum,* which accepted the contingency of all legally valid decisions based on probable assertions concerning the facts of the case or the probability that the law had been extracted from the holy sources pursuant to God's intentions.[132] If probable assertions turn out to be false, the jurist's error does not annul the legal validity and bindingness of his decision so long as sincere and diligent scrutiny of the revealed texts has been given.[133] In the *forum internum*, however, the absolute veracity of one's decisions in his relationship with God cannot be shirked; the eternal Law of God remains an absolute obligation for the individual concerned. The concept demonstrates the underlying epistemological scepticism of the jurists towards the *fiqh*. However, this is necessary for a religious law, in which the absolute truth and validity of revelation is upheld, on one hand, and the fallibility of the jurists' interpretation of those texts, comprises the other.[134]

The Islamic judge, on the other hand, was forced to evaluate individual acts, dispositions and statements of human beings. The intentions and motives of human beings (the "invisible and interior" (*bātin*)) can only be deciphered from their acts and statements (the "apparent and exterior" (*ẓāhir*)).[135] Only God knows the minds of His subjects and thus only He is in the position to punish them for their innermost convictions (which He shall do in the Hereafter).

---

[132] Johansen, "*Contingency* " (1999), 36-37. While the two spheres of law – the religious and ethical and the strictly juridical – are agreed to characterise the corpus of Islamic law, their relationship is not always able to be united in legal practice. See Johansen, "Die Sündige" (1988).

[133] Weiss, "Interpretation" (1978), 205.

[134] Johansen, "*Contingency*" (1999), 7.

[135] Ibid., 70-71.

Human judges are not in the position to judge as God would do. The human judge must arbitrate according to the appearance which legal acts and dispositions produce. [136] Thus the legality of an act or disposition in the temporal world is emphasised in a textual materialism in which the form of the law takes on greater relevance. This salient point re-surfaces in chapter four in connection with the jurisprudence of Islamic financial transactions, which evinces a formal adherence to the sharia but does not adhere to religious and ethical prerogatives. The bi-dimensionality of the law may be a helpful clue in understanding some of the motives and justifications used to develop the LIF.

Islamic law does not always attach legal consequences to relevant legal acts. Rather it is often more concerned with laying down moral norms that distinguish between forbidden and allowed transactions.[137] Accordingly, acts are classified according to whether their objects are spiritual or secular. The performance of acts with secular objects, such as the performance of certain devotional acts, secures the release of the believer from the obligation of that act. On the other hand, acts performed with a spiritual objective in mind secure a spiritual reward for the believer in the hereafter.[138]

Some acts should be performed as the omission of such acts is prohibited. These acts are either obligatory in the first degree (*farḍ*); this is the case when the rule is established in a clear

---

[136] Ibid., 24.

[137] Schacht, "*Introduction"* (1964), 121.

[138] Rahim, "*Principles"* (1994), 187-89.

and conclusive text. Other acts are *wājib* and thus obligatory in the second degree; these acts are established by probable knowledge. The payment of *zakāh*, prayer five times daily, fasting and pilgrimage are obligatory acts of the latter category. A Muslim must perform both classes of obligatory acts. She secures spiritual merit (*thawāb*) by performance and spiritual punishment (*'adhāb*) by omission. Furthermore, some acts are beneficial and yet not required. These acts are supererogatory and commended (*mandūb, mustaḥabb)*. They include the creation of a religious or charitable endowment (*waqf*), *ṣadaqah* (charitable contribution), making gifts, attending to the sick, etc. A further category of acts are forbidden and prohibited (*ḥarām*); these acts are regarded as abominable and condemned (*makrūh*). A final category of acts are neither favoured nor prohibited but are regarded with indifference. Such acts are *mubāh* (permissible) and include transactions of sale, pledge, lease and so forth.[139]

2.2.2 THE TEXTUALISM OF THE UṢŪL AL-FIQH

The *uṣūl's* emphasis upon visually apparent material attributes endowed the law with a formalistic rationality, although it was an abstract formalism. Islamic law is not concerned with the abstraction of general principles and systemic logic.[140] Rather the sharia illustrates a casuistic approach to the law that eventually gave rise to an elaborate superstructure of rules; these too were developed and based on rulings, which, for their part, were derived from other

---

[139] Ibid.

[140] Schacht, "Zur soziologischen" (1935), 214.

original rulings and the influx of new subject-matter.[141] In the subsequent chapter an examination of the system of nominate contracts provides a clear example of how this approach affected the corpus of Islamic jurisprudence in the field of commercial law.

The unrestricted use of analogical reasoning trends toward the creation of rules, originally restricted to a single description of acts, which are then extended to all acts of the same class.[142] For example, because wine is prohibited in the Quran, all intoxicants are prohibited. Or less rational: a provision ensuring general cleanliness is extended into long ceremonies of ritual purification, and so forth. Such an increasingly rigorous systematisation may preclude practical considerations of the law and limit society's ability to function. It reflects a conscious effort to systematise the law or to produce a doctrine, which was free of all presuppositions (or any contextual considerations), Arab and non-Arab, and could be restricted to the observable characteristics of the revealed language, Arabic.[143]

The necessity to return to the original texts in all matters of faith, society, religion and law in order to generate doctrine is an enduring and meaningful quality that is indicative of the development of the sharia and its unique religious and ethical spirit. And yet the essentially static nature of this requirement betrays the greatest challenge to its continuing relevance as time evolves and society progresses. Social necessities and opinion create the terms and

---

[141] Schacht, Introduction, (1964), 113 .

[142] Maine, "*Ancient* "(1885), 17.

[143] Jackson, "Fiction" (2002), 195.

circumstances to which law must respond. Indeed, even in those instances in which the law creates new sets of circumstances, human invention and nature tend to catch-up and overwhelm the law by finding any number of evasions, loopholes, or in the literal interpretation of the law, and so forth. All of these responses to legal stimuli are a result of the natural progression of social and human development. Legal rules are essentially static, and inherently indeterminate; they are created at a particular time and context, and effective only to the extent that their underlying norms are highly specific and can be applied to a particular set of factors.[144]

The *uṣūl al-fiqh* came to fruition only after a body of Islamic jurisprudence had been developed. Yet legal theory played more than just a rhetorical and descriptive role. It established a strict textual hermeneutic that, nonetheless, was not free from human error. While its epistemological difficulties could be overcome, jurists' subscription to the hermeneutic created a highly casuistic

---

[144] Black, "*Rules"* (1997), 199. By the beginning of the fourth century many modern scholars argued that the activity of *ijtihād* had ceased to take place; that, in fact, Muslim jurists had agreed to practice *taqlīd* or juristic conformity with the already established doctrines of the *madhhab* and the legal theory (*uṣūl al-fiqh*) that had developed until that time. For example, Joseph Schacht argued that jurists "felt that all essential questions had been thoroughly discussed and finally settled, and a consensus gradually established itself to the effect that from that time onwards no one might be deemed to have the necessary qualifications for independent reasoning in law, and that all future activity would have to be confined to the explanation, application and, at the most, interpretation of the doctrine as it had been laid down once and for all". See Schacht, "*Introduction "* (1964), 70-71. Known as the "closing of the gate of *ijtihād*" (in Arabic: *insidād bāb al-ijtihād*), *taqlīd* was to have demanded an unquestioning acceptance of the school doctrines. The *mujtahid* or the jurist entitled to perform *ijtihād* was no longer said to exist. However, Hallaq convincingly demonstrates that jurists capable of exercising *ijtihād* existed at all times, in all centuries. Moreover, *ijtihād* contributed to developing the positive law of school doctrine (*fiqh*) in the period of *taqlīd*. For more see Hallaq, "the Gate" (1984).

law built upon the edifice of analogical reasoning. The following section examines a further unofficial source of Islamic law, namely, custom.

2.3 THE ROLE OF CUSTOM

Custom has been defined as a form of life rooted in a people's sense of propriety,[145] and as a whole body of usages, practices or conventions, be they social, economic or other, which regulate social life from the grassroots level.[146] These tend to be established practices, a usual way of doing things, and adherence to these folkways is an expression of membership to a particular community. The more homogenous a society is, in terms of its racial, ethnic and cultural background, the stronger such a tendency is likely to be.[147] Custom, unsurprisingly, is not one of the classically recognised sources of Islamic law; yet it is employed and called upon to such an extent that, in actuality, it is not only a major source of law, but an aspect of social life which the sharia has often left to its own devices.

The refusal to recognise custom as a formal source is grounded in the doctrine of the spiritual essence of the sharia which is fundamentally opposed to human tampering with God's law. The juristic methodology sought to distance the law from the bedrock of customary practices which

---

[145] Geertz, "*Local Knowledge*" (1983), 210.

[146] Merriam-Webster's Online Dictionary, "Custom" (2009).

[147] Stein, "*Institutions*" (1984), 3.

had bequeathed to the new community the very foundations of the sharia.[148] Paradoxically, however, it is the universal claim of Islam, its willingness to envelop and acquire the novel mosaic of customary practices that it met through siege and conversion, which enabled Islam to accept customs and imbue them with the Islamic spirit.[149] It is this universal legitimising claim, on the one hand, and the divinely inspired doctrine, on the other, which have enabled Islam to straddle the sometimes uneasy chasm between theoretical ideals and the law applied.

Yet it would simplify the relationship of customary practices to the sharia, and vice versa, by viewing their enmeshed relationship in discreet categories or institutionalised identities whose authority lies in their struggle with each other for legitimacy and identity.[150] The authority and influence of the sharia extended to every domain of Muslim social and religious life. It permeated all other conceptions of knowledge or practice so as to render their distinctiveness not only impracticable but without utility.[151] Thus the demand for universality rendered Islamic all sorts of practices and these, in turn, reciprocated by allowing indigenous social practices to flourish within the broader confines of Islamic doctrine. It is probably the inclusiveness of Islam's universal values that accounts for the rapid spread of Islam amongst disparate local traditions. In sum, drawing too fine a line between custom and theory, between the formal and informal, may distort the nature of Islam to the extent that its distinctiveness as a universalising religion is lost to the observer.

---

[148] Libson, "Custom" (1997), 135.

[149] Udovitch, "Constitution" (1987), 166.

[150] Gluckman, "*Barotse*" (1955), 261-62.

[151] Rosen, "Custom" (1995), 201.

Substantial historical evidence underscores the controversy concerning custom's role as a formal source of law in the classical period, and yet a *de facto* recognition of its importance is revealed in Muslim legal literature. Quasi-recognition of certain customs was made possible by resorting to other more legitimate legal tools such as *istiḥsān* or by linking these to *ijmā'*, both of which became a common means for assimilating popular custom into the law. Likewise the principle of *ḍarūrah* (necessity) was utilised for the same purpose.[152]

The introduction of Hadith collections in the latter part of the 9th century proved to be an essential means of incorporating age-old and recent customary practices into the sharia without diverging from the principles of the *fiqh*. Because the Sunna is, in essence, the living custom or tradition of the Prophet Muhammad, customs originating elsewhere could be identified with the Sunna and accorded divine legitimacy.[153] However, the incorporation of foreign elements was not limited to customary usages. All sorts of ideals and common adages reflective of the then contemporary scholars' wishes for the developing doctrine were projected back to the time of the Prophet and given religious legitimacy.[154] For example, a common maxim often invoked to justify the use of "rationalising legal tools"[155] reminded the followers that religion had been

---

[152] Libson, "Custom" (1997), 151.

[153] Ibid., 138.

[154] Goldziher, "Muhammedanisches" (1888), 423.

[155] "Rationalising legal tools" are those legal instruments that are used in the practice of *ijtihād*. They are "rationalising" because they allow jurists to use their individual discretion (*ra'y*) in determining a solution to a novel legal problem. Some writers have referred to them as "legal scaffolding" or "legal fictions".

bestowed upon the community, not to bring hardship but to ease their sufferings. And thus Muhammad was to have expressed this adage to the Companions in his midst.[156]

Some evidence of this incorporation exists in the fact that legal literature does not mention custom as a material source, i.e. its association with *istiḥsān*, as long as the redaction of the Hadith collections was taking place. Once the standard Hadith collections had been finalised at the beginning of the 9th century, discussion of custom as a material source becomes frequent and was subsequently woven into the fabric of the law.[157] This is particularly the case in commerce and trade, wherein jurists without qualm or hesitation invoked the domain of custom (*'urf*) or the 'practice of the merchant *('ādat at-tujjār)* in the formulation of contracts and in the settlement of disputes. Indeed, large swathes of commercial conduct and the legality of its practical details are left untouched and unchartered due to the omnipresence of the inherently amorphous notion of custom.[158]

Commercial customs were introduced into the law through the framework of dispositive law, i.e. via contract and stipulation by the parties. Thus custom has the authority to determine the rights and duties of contracting parties when these have agreed stipulations to that extent. Even in the absence of such stipulations, scholars representing nearly all the *madhabs* voiced

---

[156] Goldziher, "Muhammedanisches" (1888), 419.

[157] Libson, "Custom" (1997), 139.

[158] Udovitch, "Constitution" (1987), 160.

support for the interpretation of contracts with a view to the customary practices prevalent in the area in which they were carried out.[159]

With the passing of time and the increasing complexity of commercial exchange, custom has come to be recognised as a quasi-source of law, particularly within the Ḥanafī school. The post-classical period was witness to this transformation in the formulation of the *Mejelle*, whose authors compiled rulings on custom in ten articles.[160] Following this break with the theory of classical jurisprudence, the gradual inculcation of custom as a formal source has been adopted by modern Muslim jurists who have attempted to legitimise their position through a revisionist view of the primary sources.[161]

2.4 THE ROLE OF CUSTOM IN CLASSICAL COMMERCIAL LAW

The general consensus amongst early Western scholars of Islam, including Goldziher, Hurgronje, Bergsträsser, and Schacht, has been that a pattern of Islamic belief developed in which believers took little notice of the sharia with respect to the practical requirements and transactions of daily life (*muʿāmalāt*); but in introverted fashion, placed great emphasis upon the uncompromising ideal doctrine,[162] particularly in those areas of private law associated with the

---

[159] Ibid., 153.

[160] Ibid., 141.

[161] For an example of modern revisionism that seeks to adapt the sharia to modern circumstances see Ramadan, "W*estern Muslims"* (2004).

[162] Hurgronje, *"Islamic Law"* (1957), 290.

institutions of the family, ritual and inheritance. However, recent scholarship convincingly argues that jurists' detailed treatises and other legal works elaborated the primary classical institutions of commerce, including partnerships (*shirkah*) such as the *muḍārabah* in surprising conformity with the way in which medieval commerce was practiced.

Historical documents from the Cairo Geniza – a wealth of documentary material describing medieval civilisation of the Middle East from the 10th to the 16th centuries (the Fatimid and Ayyubid dynasties)[163] underscore the assertion that, in fact, scholars paid frequent attention to the commercial practice of the late eighth century. Their writings reflect a very detailed and elaborate discussion of commercial practices prevalent in the Near East in the medieval period.[164] However, the historical record suffers from the almost "complete absence of any actual documents or records from the first few centuries of the Islamic era".[165] In particular, historical records of medieval trade and commerce prior to the tenth century are almost non-existent or are yet to be discovered.[166] Hence, Udovitch's analysis hinges on documentary evidence that originates, at the earliest, from the 10th century. And even these are hard to come by as Goitein notes that *Geniza* documents from the 10th century are comparatively few in number.[167] The authoritative works of the schools of law in the earliest Islamic centuries cannot be viewed as historical records of actual economic and commercial transactions. They may, in

---

[163] See Goitein, "Geniza" (1955), and "*Mediterannean*" (1967).

[164] Udovitch, "Law Merchant" (1970), 115.

[165] Udovitch, "Western Commenda" (1962), 202.

[166] Lopez and Raymond, "*Trade*" (1955), 18.

[167] Goitein, "Geniza" (1955), 78.

fact, reflect an idealistic conception of the law. However, classical legal literature dating from the 9th century has nonetheless provided valuable insights into the social and economic institutions of the classical Islamic world and in this regard has proved particularly illuminating in helping scholars piece together an otherwise poorly documented canvass of Muslim social life.[168]

The jurisprudential emphasis on commercial practice is seen not only in the "eminently practical and functional" aspects of Ḥanafī commercial law, but also in their frequent writings in which scholars refer to the commercial imperatives of the "the custom of the merchants" or "the needs of the people".[169] Therefore, the earlier view that a rigid separation between doctrine and practice best described Islamic commercial law may not always have been the case. In fact, it seems that some of the more rigid aspects of doctrine were ameliorated by granting a wide berth to the role of custom in commercial transactions.

Early Muslim legal literature underscores the supremacy of the concept of 'custom' in commercial exchange as a decisive feature of the laws of commerce.[170] The prevalence of custom was not relegated or confined to the details of the law, but permeated the form and general character of the central institutions of commercial activity.[171] With respect to an entire corpus of commercial practice, such as the all-important and ubiquitous use of weights and

---

[168] Udovitch, "Constitution" (1987), 152.

[169] Hurgronje, *"Islamic Law "*(1957), 290.

[170] Mallat, "Commercial Law" (2000), 95-96.

[171] Udovitch, "Law Merchant" (1970), 124-25.

measures, the means of transportation, the appointment of agents for the purchase and sale of commodities, even the semantic definition of descriptive terms when applied to certain commodities, the final arbiter of commerce is none other than custom. Thus it is the habitual practice of the merchants *(ʻādat at-tujjār)*, the general manner of commerce (*wajīh al-tijārah*) or the usual practice of the people *(al-mutaʻārif bayna al-nās*) which busied the minds of jurists who clearly sought to enable Muslim entrepreneurs and merchants to succeed in meeting the material and subsistence concerns of the community.[172] In many ways the commercial elaborations of the sharia reflect a diverse set of customary business practices – many derived from ancient foreign origins – in the medieval Middle East.

However, a tension between doctrine and the actual practice of the law did exist. It is evidenced in the use of contractual formulae, the *shurūṭ*, for formal, private transactions. Islamic doctrine denied the validity of the use of written documents in a sharia court, despite an explicit ruling in the Quran at *Sūra* 2:282 which commanded: "When you contract a debt for a fixed term, record it in writing. Let a scribe record it in writing between you […] Be not averse to writing down [the contract], whether [the amount] be small or great, with its term". Yet oral testimony provided the only form of formal proof inasmuch as the personal testimony of an upright Muslim was deemed much more worthy than a written document, which may have been falsified and/or have dubious origins. A private contract required at least two male witnesses, or two female witnesses for every male, and public documents required court-hired witnesses.[173]

---

[172] Udovitch, "Constitution" (1987), 162.

[173] Wakin, "*Documents"* (1972), 6-7.

The use of witnesses (*shahādah* in the wider sense) was not an Islamic invention, but was common throughout the pre-Islamic Near East. In pre-Islamic Arabia the use of witnesses for giving evidence was almost certainly the most common form of proof, and ceremonies may have been performed for their reception.[174] Therefore, it would seem that the institution of witnesses fulfilled an ancient practice prevalent in the pre-Islamic Near Eastern civilisation. The legal invalidity of written documents at the sharia may simply highlight an aspect of the law which – despite the religious and ethical imprint of the *shahādah* – remained procedurally immune to the divine revelations.

It can be concluded that customary practices played a very significant role in the Islamic law of commerce. On the basis of Udovitch's seminal research, it also seems likely that Ḥanafī legal doctrine comprised a wide range of customary business practices prevalent during the classical period. In the modern world Islamic finance may, in fact, constitute a desire to reintroduce the customary practices of the classical Islamic commercial tradition.[175] In the modern world jurists have appropriated conventional financial practices with the assistance of rationalising legal tools. The particular approach to articulating the LIF will be examined in chapter four. In the next section some of the legal concepts and tools used to import customary practices, and to adapt and extend the law, more generally, are considered.

---

[174] Ibid.

[175] Mallat, "Commercial Law" (2000), 124.

2.5 MAṢLAḤAH AND RATIONALISING LEGAL TOOLS

This section focuses on the principle of *maṣlaḥah* (public interest) and the legal tools created to give it effect. *Maṣlaḥah*, referred to as *istiṣlaḥ* in technical legal terms, literally means a source of something beneficial or good.[176] More generally, it refers to prohibiting or permitting a legal act or disposition on the basis of "public interest".[177]

Fatwas based on considerations of *maṣlaḥah* are found in some of the earliest legal writings from the 2nd/8th and 3rd/9th centuries. However, the principle attained widespread acceptance only in the late 5th/11th century when the Shāfiʿī jurist al-Ghazālī (d. 505/1111) established that the "*maṣlaḥah* was God's purpose (*maqṣad*, pl. *maqāṣid*) in revealing the divine law".[178] Al-Ghazālī asserted that God's revelation of divine law was designed to preserve the five essential elements of human welfare: namely, religion, life, intellect, offspring and property. The protection of these essential elements or what averts harm from them is considered a *maṣlaḥah*; the endangerment of these elements constitutes its opposite, namely, *mafsadah* (evil).[179] *Maṣlaḥah* is generally categorised according to three types: these are the 'essentials' (*ḍarūrīyāt*); the 'complementary' (*hājīyat*); and the 'embellishments' (*taḥsīnīyāt*).[180]

---

[176] Opwis, "Islamic Law" (2007), 62.

[177] Aghnides, "*Theories*" (1961), 97.

[178] Opwis, "Maslaha" (2005), 187-88.

[179] Ibid.

[180] Kamali, "*Principles*" (2003), 356.

The use of *maṣlaḥah* as a means of effecting legal change was and still is controversial. The controversy centres on whether or not the human intellect is able to discern *maṣlaḥah* without a concrete textual indication (*dalīl*) in the revealed sources. Known technically as *maṣlaḥah mursalah* or unattested *maṣlaḥah,* this type of *maṣlaḥah* pertains to matters in which no textual authority can be located. The challenge for jurists was and still is to devise legal strategies in which *maṣlaḥah* can be utilised in a legally valid manner. [181]

Amongst the eponymous founders of the *madhhabs* Al-Malik is the most outspoken supporter of *maṣlaḥah* as "a proof and basis of legislation (*tashrī*)".[182] Al-Malik held that not upholding *maṣlaḥah* when it is compatible with the objectives of the law or falls within the categories or genus of what God has expressly permitted would be to neglect God's law. As such *maṣlaḥah* constitutes an integral norm of the sharia.[183] The Ḥanbalīs adopted a similar position.[184] On the other hand, the Ḥanafīs and Shāfiʿī s held that *maṣlaḥah* constitutes a valid ground for legislation only in the presence of a textual indication as indicated in the *ʿillah* of a given text or in the general objectives of the revealed texts. This requires the type of enquiry used in determining the *ʿillah* in *qiyās* and is thus designed to limit arbitrariness in the formulation of the law.[185] Despite their different approaches to the principle, however, all four schools of law

---

[181] Opwis, "Maslaha" (2005), 191.

[182] Kamali, "*Principles"* (2003), 355.

[183] Ibid.

[184] Ibid., 364.

[185] Ibid., 362.

agreed that an instance of *maṣlaḥah*, which did not conflict with the objectives of the revealed sources, should be upheld.[186]

Rationalising legal tools such as *istiḥsān, istiṣlāḥ* and *ṣadd al-dharā'i'* (blocking the means) were created by the scholars to give effect to the general interest (*maṣlaḥah*) of the Muslim community. Although each term is denoted differently, their varying nomenclature merely serves to identify their particular method but, in essence, they all are designed to promote *maṣlaḥah*.[187] For example, *ṣadd al-dharā'i'*, (literally: closing the gates to evil), prevents a lawful act from taking place that may eventually lead to an unlawful act. Its ultimate objective is to establish *maṣlaḥah*.[188]

Rationalising legal tools serve as an important vehicle in adapting and extending the law. In essence, they are designed to limit the damage and inconvenience of a formalist interpretation.[189] They satisfy society's desire for progress and improvement while, at the same time, not offending sacred or other authoritative instances disinclined towards change.[190] They are constructed to conceal, or affect to conceal, the fact that a law has been altered, its letter remaining true, but its spirit wholly modified. These and other mitigating effects were particularly necessary in the post-formative phase of jurisprudence in which jurists may have

---

[186] Ibid., 365.

[187] Dien, "Maslaha" (2000), 348.

[188] Ibid., 351.

[189] Jackson, "Fiction" (2002), 195. Jackson refers to these as 'safety-net' principles.

[190] Maine, "*Ancient*" (1885), 26.

operated under a regime of *taqlīd* (conformity), since they were charged with maintaining a genetic connection with the *mujtahids* of old. It became necessary to invent new exceptions and classifications, to manipulate the wording and scope of legal injunctions to accommodate a changed reality and thereby erect a sort of 'legal scaffolding'.[191]

However, the pursuit of rationality in the interpretation of the sharia is at odds with the *uṣūl al-fiqh*'s strict procedures for deriving legal rulings. Yet the predominance of Ash'arī textualism left unanswered the problem of how jurists were to know God's law when a novel legal problem came to light and a scriptural indicant was not available.[192] Rationalist legal tools provided an indispensable means of adapting and extending the law to new and changing circumstances where a strict adherence to the *uṣūl al-fiqh* would have stymied the applicability and relevance of the law as time and circumstances changed.

Yet such tools possess the distinct disadvantage of creating a law lacking a guiding coherence expounded in logical deduction and which is subject to arbitrariness, subjectivity and legal uncertainty.[193] Furthermore, when any novel problem can be decided by human reasoning, unaided by indicants located in the scriptural sources, the body of jurisprudence that is

---

[191] Alan Watson, "*Nature"* (1977). Watson is the first to have used the concept of "legal scaffolding". Jackson, "*Islamic Law "* (1996), 98-99. Jackson has applied the concept with respect to Islamic jurisprudence.

[192] Opwis, "Maslaha" (2005), 190.

[193] Ibid., 191-92.

attributable to revelation will consistently decrease over time.[194] The resulting secularisation of the law is an unviable alternative for a religious law.[195] The following section concerns the use of legal stratagems designed to circumvent the substance of the sharia.

2.6 LEGAL STRATAGEMS (*ḤIYAL*)

Islamic jurisprudence also makes use of legal stratagems known as *ḥiyal*, (sg. *ḥīlah).* Ibn Qayyim al-Jawzīyah (d. 751/1350) wrote that *ḥiyal* represent the subtle management of aspects of a legal transaction in ways for which they were not intended.[196] However, for those who ascribed to these means, one could utilise *ḥiyal* to make lawful that which otherwise is unlawful; to create what the Ḥanafīs called "*makhārij*" (sg. *makhraj*) or 'exits'.[197] *Ḥiyal* represent an attempt by the jurists to ease the difficulties posed by scrupulous adherence to the sharia without having to trespass the divine laws on account of the exigencies of everyday life.

Ḥiyal are devised to seek a compromise between theory and practice, between ideals and reality.[198] Schacht made the largest-to-date contribution to contemporary understanding of *makhārij* with his translation of four published works dedicated to expounding these 'ruses', as he called them; these included those by Abū Bakr Aḥmad al-Khaṣṣāf (d. 874), Abū Ḥātim

---

[194] Ibid., 191.

[195] For more on this process see Layish, "Secularisation" (1978). And Coulson, "Progress" (1964), 25.

[196] C.f. Horii, "Reconsideration" (2002), 312-13.

[197] Ibid.

[198] Schacht, "*Das kitāb"* (1924), 6.

Maḥmūd al-Ḳazwīnī (d. 440/1048-49) and Muhammad Ibn al-Ḥasan al-Shaybānī (d. 189/805).[199] Three of the works are by Ḥanafīs and the fourth by al-Ḳazwīnī, a Shāfi'ī jurist. Shaybānī was one of Abū Ḥanīfah's most brilliant disciples. His writings constitute some of the basic texts of Ḥanafī jurisprudence, which include the *Kitāb al-Aṣl, al-Jāmi 'al-kabīr* and *al-Jāmi 'al-ṣaghīr* – the so-called '*ẓahir al-riwāya*', i.e. the authoritative and faultless transmission of Ḥanafī doctrine. The *ẓahir al-riwāya* contains the three major scholars of the Ḥanafī school: Abū Ḥanīfah (eponym of the school), Abū Yūsuf, and Shaybānī.[200] It is therefore evident that the *makhārij* are an authoritative and illustrative feature of Ḥanafī jurisprudence, and not merely obscure works by less well-known authors whose views bore little impact.

Ḥiyal were employed in nearly all facets of life. They were not reserved for those areas of social transaction that, for the Western reader, are more closely associated with legal transactions. However, the chapters of the *fiqh* devoted to spiritual matters *('ibādāt*) comprise a much smaller proportion of *ḥiyal,*[201] which probably indicates that the practice of ritual worship is more closely aligned with the ideals of the law.

Hence the Ḥanafīs acquired a well-earned reputation for the systematic use of *makhārij,* although the Shāfi'ī s were known to have utilised them as well.[202] Abū Ḥanīfah is said to be the

---

[199] Rodinson, "*Islam"* (1974), 36.

[200] Horii, "Reconsideration" (2002), 327.

[201] Schacht, "hijāl-Literatur" (1926), 213.

[202] Saleh, "*Unlawful Gain"* (1986), 61. Also Horii, "Reconsideration" (2002), 312-18.

founder of the genre despite the fact that he did not compose a treatise on the subject. Many statements concerning *ḥiyal* in standard Ḥanafī texts are attributed to him.[203]

A book of *ḥiyal (kitāb al-ḥiyal*) written by al-Shāfiʿī or one of his early disciples would have been unthinkable inasmuch as a lively polemic was directed by this school against the Ḥanafī works devoted to the subject. The Shāfiʿī experiment with *ḥiyal* seems to be more of an intellectual exercise of competition with the Ḥanafīs after the schools had consolidated their authority and legitimacy as a recognised *madhhab*. [204] In this regard, their devices are not as practically oriented as are the Ḥanafī *ḥiyal*.

The Ḥanafīs' recommendation of their use stretches far beyond a limited exercise. Ḥanafīs encouraged the faithful to utilise them, even to avoid merely undesirable situations, since the law provides for these exits for those who seek them. Ibn Qayyim al-Jawzīyah confirmed this claim in his description of the Ḥanafī view regarding the sharia as a body of exits that envisioned the exigencies of human life.[205] It is apparent, therefore, that the Ḥanafīs regarded the law in terms of its utility. *Makhārij* were devised to help the faithful seek remedies for 'oppressive' or inconvenient situations that 'prejudiced' oneself.

---

[203] Horii, "Reconsideration" (2002), 319.

[204] Schacht, "*Das kitāb"* (1924), 6.

[205] Horii, "Reconsideration" (2002), 321.

The Mālikī or Medinese position on *ḥiyal* invoked the principle of *ṣadd al-dharā'i'*. It has been described as the antithesis of *ḥiyal* in the sense that it seeks to block unlawful acts for presumably illegal purposes despite their otherwise lawful appearance.[206] The principle became instrumental to later criticism of *ḥiyal*.

A well-known example of *ḥiyal* is one of the oldest of its kind, the *bay' al-inah* or the double-contract sale. An object is sold on a deferred payment basis, but then bought back for a sum less than the original deferred price, payable on the spot. This is, in essence, an interest-bearing loan. The transaction was so successful and widespread that Europeans of the Middle Ages adopted its use under the name of *mohatra* (from the Arabic, *mukhāṭarah*, meaning risk).[207] Most jurists found the transaction impermissible but, interestingly, Muzanī notes that al-Shāfi'ī treated the sale as valid.[208] This particular *ḥiyal* plays a very important role in many sales-based Islamic financial transactions.

Therefore, the Ḥanafīs justified the incorporation of *ḥiyal* into their legal doctrine not as an attempt to circumvent the law but rather sought to utilise the law according to its underlying spirit, which provided for "exits". *Ḥiyal* were, by definition, legitimate, and were thus transmitted as a special genre of Ḥanafī doctrine.

---

[206] Ibid., 343.

[207] Schacht, "Ribā " (1936).

[208] Horii, "Reconsideration" (2002), 346.

CONCLUDING REMARKS

Despite the strict hermeneutic which guides jurists in their *ijtihād*, Islamic jurisprudence contains a number of legal tools and methods to adapt and extend the law to changing needs and circumstances.

The Quran is the first and most sacred source of Islamic jurisprudence. However, the Quran contained little "strictly" legal material that early religious specialists could use to develop a body of Islamic law. Therefore, they had recourse to their personal discretion (*ra'y*) and the ancient customary practices of the Arab *Sunna.* Together these sources formed the raw material of the fledgling law.

By the end of the 2nd/9th century the *madhhabs* increasingly recognised the superior authority of Hadiths that originated from the Prophet as opposed to the ancient Arab Sunna or established doctrines of the schools. The eventual triumph of the authority of prophetic Sunna ushered in a much more systematic composition in the law. A direct result was that human reasoning or *ra'y* – long used to create a body of Islamic jurisprudence – became viewed unfavourably in that it represented human tampering with God's law. By the middle of the 3rd/9th century prophetic Sunna became established as the second formal source of a growing body of Islamic jurisprudence. In terms of the legal material that eventually found its way into the law, however, the Sunna became the most important source.

The theological and juristic debates that culminated in the victory of prophetic Sunna over ancient Arab Sunna and school doctrine gave rise to two further sources of law: *ijmā'* and *qiyās*. These further sources not only consolidated the structure of the law (*ijmā'*) but enabled it to grow through a process of inferential reasoning (*qiyās*). With the theorisation of Islamic legal theory (*uṣūl al-fiqh*) finally in place the strict textual hermeneutic offered a normative and descriptive guide to the jurist in his interpretation of the law.

While legal theory called for the review of the revealed sources in the event that a novel legal problem arose, in practice jurists' practice of *ijtihād* had frequent recourse to other unofficial sources of law; amongst them custom was amongst the most important. Particularly in the area of commercial and financial transactions the accommodation of customary business practices figured prominently in jurists' legal writings. Jurists also embraced the concept of *maṣlaḥah* and the rationalising legal tools that gave it effect. Together these tools enabled jurists to adapt and extend the law to new and changing circumstances.

Finally, legal stratagems known as *ḥiyal* were created to circumvent the substance of sharia provisions while complying with the letter of the law. In sum, the unofficial sources of law provided a counterweight to strict legal theory and facilitated the relevance and growth of the law as time and needs evolved. The following chapter is concerned with Islamic commercial doctrine.

CHAPTER THREE: ISLAMIC COMMERCIAL DOCTRINE AND CLASSICAL COMMERCIAL TRANSACTIONS

INTRODUCTION

This chapter concerns classical Islamic commercial law. It is asserted that Islamic commercial doctrine generally restricts contracting parties' freedom to contract. Yet various legal concessions offset the rigidities that would otherwise restrict commerce and trade.

The chapter begins with an analysis of the theological conception of the Islamic contract and the resulting system of nominate contracts. Second, the pivotal prohibitions of *gharar* and *ribā* are considered. Finally, the Cairo Geniza records are analysed with regard to the rules and concepts developed herein.

3.1 GOD'S COVENANT WITH MANKIND

Classical Muslim thought is unanimous with respect to a human being's native endowment, a God-implanted ability, to know with absolute certainty of God's existence. Known as *fitra,* this universal concept describes one's ability to reason one's way to an unshakeable knowledge of God and to its attendant obligations. The pursuit of the knowledge of God ushers one into a covenantal encounter with Him. To know God is to stand before Him as a presence before

whom one stands in a covenantal relationship.[209] This relationship is enunciated in the seminal passage detailing the covenant: "And [remember] when your Lord brought forth from the Children of Adam, from their loins, their seed, and made them testify against themselves [saying]: Am I not your Lord? They said: Yes, verily. We testify. [This was] lest you should say at the Day of Resurrection: Lo! Of this we were unaware".[210]

The orthodox interpretation of divine revelation insists that all obligations to which human beings are subjected arise out of the covenantal encounter between God and mankind. This relationship is vastly unequal as befitting the superiority of God vis-a-vis His subjects. Thus, the passage is descriptive of two parties to the covenant: God, the Lord, who dictates the terms of the relationship, and mankind, an inferior, who submits to those terms.[211] The covenant describes the rights and responsibilities of mankind and enunciates the consequences both of compliance and non-compliance.[212]

The Muslim believer owes his obedience to God. His faithfulness or loyalty (*amānah*) to his pledged word is made in His presence so that God is witness to the conclusion and binding nature of all contracts. Several verses in the Quran highlight the divine importance of keeping one's oaths and agreements. For example: "Verily those who swear allegiance to thee, swear allegiance really to God, the hand of God is above their hands; so whoever breaks faith, to his

---

[209] Weiss, *"Spirit"* (1988), 26-31.
[210] Quran 7: 172.
[211] Weiss, "*Spirit"* (1988), 31-32.
[212] Ibid., 93.

own hurt he breaks it, and to those who fulfil what they have pledged to God, he will one day give a mighty reward […]".[213] Likewise oft-cited verses that remind believers to hold tight to their pledge illustrate the general tenor of such commandments: "Ye who believe! Fulfil all obligations;"[214] and "Fulfil the covenant of God when ye have entered into it and break not your oaths after ye have confirmed them".[215] From the primordial covenant the Islamic laws of contract were developed by jurists. Thus, the sharia, not unlike the Western legal principle of *pacta sunt servanda,*[216] underscores the sanctity of contract.

However, the ever-present ethical concerns of Islamic law differ from the Western legal principle, as contracting parties are given the means to cancel unilaterally a validly concluded contract, if necessary. Known as the option of rescission (*faskh*), they are designed to ensure that the agreement between the parties is real and not just apparent and that the parties are satisfied and committed to the fulfilment of their mutual obligations.[217] Hence, the principal ethical aspiration embedded within the Islamic law of contracts seeks to extract the highest degree of certainty in the rights and obligations amongst the parties. The extinguishment of the option, either by agreement or forfeit, triggers the mechanism whereby the contract is endowed with binding legal force.[218]

---

[213] Quran 48:10.

[214]Quran 5: 1.

[215]Quran 16: 91.

[216] Ballantyne, " Shari'a" (1987), 12; Ballantyne, "Commercial" (1997), 228.

[217] Coulson, "*Commercial Law"* (1984), 57-58.

[218] Ibid.

The option may only be attached to contracts which involve consideration and are to be legally binding. Where these criteria do not exist, the option to rescind does not come into play. Straightforward contracts such as sale (*bay'*) and hire (*ijārah*) fulfil these criteria, while valid but not binding contracts such as partnership (*sharikah*), agency (*wakālah*) and reward (*ju'ālah*) are revocable by either party.[219] The system of options is varied and complex and will not be pursued further here. However, it is one of several features of Islamic commercial law that distinguish its underlying ethical impetus from the absolute binding nature of the Western maxim.

3.2 THE ROLE OF INTENTION (QAṢD)

Muslim scholars agree that human will alone (*irādah*) does not create rights and obligations, the central elements resulting from the conclusion of a contract. While they agree that human intention (*qaṣd*) is responsible for triggering the commencement of the contractual process, the effects of the contract are produced immediately and irrespective of what the parties have agreed. Thus the contract becomes a mere exchange of rules, wherein the role of human will (*irādah*) is curtailed dramatically.[220] The will of the author of a contractual declaration has almost no place in the Islamic scheme of nominate contracts. Chehata emphasises: "If the spirit

---

[219] Ibid., 61. Kuran has stirred controversy by arguing that the Islamic laws of partnership stifled the economic development of Middle Eastern civilisation. See Kuran, "*Divergence"* (2011).
[220] Comair-Obeid, "*Contracts"* (1996), 6.

of the person making the declaration is to have in view the effects of the declaration, his will is in no way attached one way or another to the contents of the declaration. This content, by which is meant the signification of the declaration, is realised by virtue of the law. The will cannot by its own virtue create rights and obligations".[221]

Seen in this light, the contract in Islamic law is a cause (*sabab*) that flows from the sharia. It produces effects (*aḥkām*) in terms of rights and obligations, equally foreseen by the law.[222] Most contemporary Muslim theorists perceive the element of intention (*qaṣd)* as a choice (*ikhtiyār*) at the moment of declaration, a primordial element in the formation of the contract. Thus, according to theology, freedom in contracting exists only at the level of the *ikhtiyār*.

The emphasis placed upon the role of intention (*nīyah*), rather than will, has led to the willful underdevelopment of cause (*sabab*) as a juridical structure in Islamic law.[223] In its stead jurists stress the important role that Islam places on the detailed nature of the rules concerning parties' contractual consent, and most especially, concerning the subject matter of the legal act. The richness of this legal matter, they argue, is sufficient to determine which legal acts should be cancelled.[224]

---

[221] Ibid.

[222] Ibid.

[223] Saleh, "Cause" (1992), 117.

[224] Ibid., 120-21.

Consequently, the reduced role of intention in secular transactions (*mu'āmalāt*) as opposed to the realm of worship *('ibādāt*) – where the importance of intention is undisputed – is evidenced in the differential treatment applied to the concept by the four schools of law. Al-Shāfi'i, writing in his famous *al-Umm* (the Mother), emphasised the appearance of validity of the contract which cannot be cancelled based on the suspicion or previous practices of the parties. An unlawful intention is reprehensible (*makrūh*) but it does not cancel an agreement or disposition so long as it is not expressed.[225] Likewise, the Ḥanafīs stressed the validity of a contract based upon its appearance despite circumstantial evidence indicating an act's unlawfulness.[226] The Ḥanbalīs and Mālikīs foresee a greater role for the will, however, and hence the immediate purpose or cause receives greater emphasis. Therefore, Ḥanbalī and Mālikī jurists annul any agreements or dispositions whose authors' intentions are suspected to be unlawful.[227] As remarked in chapter two, the LIF has been profitably constructed to avail itself of this important concept. The following section examines the system of Islamic nominate contracts.

3.3 THE SYSTEM OF ISLAMIC NOMINATE CONTRACTS

The term *'ahd* is used frequently throughout the Quran and seems at times to be a synonym of *'aqd* (pl. *'uqūd*), although the latter is normally used to refer to bilateralism,[228] or to a bilateral economic exchange between parties. From the covenant or *'ahd* flow all other obligations, i.e.

---

[225] Ibid., 123.

[226] Ibid., 125.

[227] Ibid.

[228] Hallaq, "Contracts" (2008).

commandments and rules, which God also demands of his slaves. The Arabic word for contract, *'aqd*, is invoked only once in the Quran, in *Sūra* 5:1, cited above. However, *'aqd* appears consistently in the classical works of Islamic law[229] and is thus commonly used to denote the juridical operations concluded between parties. In its more secular interpretation the Islamic contract is a legally recognised undertaking or juridical act, which is not necessarily used to denote an agreement. The term also describes unilateral juridical acts and dispositions by will (*mortis causa*) such as gifts, bequests, gratuitous loans, guarantees and so forth that do not require the consent of any other party. Moreover, the system of contracts includes mere juristic acts that do not require consideration, such as the repudiation of marriage by the husband (*talāq*) and the manumission of a slave.[230]

Jurists laid down no less than thirty specific nominate contracts, nearly all of which were modelled on the contract of sale. In fact, some modern scholars of Islam view the contract of sale as a substitute for a general theory of contract, which itself is "probably too occidental and systematic an approach" to impose upon the Islamic body of law.[231] In fact, the exceptions between the nominate contracts far outweigh the generalities amongst them.[232]

---

[229] Rayner, "*Contracts"* (1991), 88.

[230] Ibid.

[231] Ibid., 89.

[232] Coulson, "*Commercial Law"* (1984), 27-31.

The jurist's casuistic approach to the law was inclined to elicit subtle rules pertaining to specific contracts rather than formulating broad theories.[233] In particular, *qiyās* was used to elicit additional contracts and the development of intricate rules pertaining to each commercial contract. The resulting category of contract was subsequently authorised by Hadiths or other legal sources.[234]

A scheme of nominate contracts emerged in which contracting parties could seek out a valid and effective nominate contract heading amongst an array of basic and exceptional contract types. So for example, a contract of sale for agricultural commodities that had not yet been sown would be deemed null and void as it involved uncertainty as to the existence of the object of contract – comprising the central element of the prohibition of *gharar*. However, parties could choose another contract heading such as the *salam* (forward purchase) in which the non-existence of the commodity is permissible and proceed with the exchange. Hence the rigid formality of the nominate contract system was minimised to a considerable extent.[235]

Classical jurists generally categorised the system of contracts into four branches, based on a classification as to whether the exchange is of the corpus or the usufruct, and whether it is for a consideration or not. These four contracts are often mentioned in the *fiqh* literature but, as seen, the contract of sale receives greatest emphasis as it tends to act as a hypothetical model

---

[233] Rayner, "*Contracts"* (1991), 91.

[234] Ibid., 100.

[235] Coulson, "*Commercial Law"* (1984), 30.

from which other contracts originate. The four classifications are: (1) *bay'*, which denotes the transfer of the corpus for a consideration; (2) *hibah* (gift), the transfer of a corpus without consideration; (3) *ijārah* (lease, hire), the transfer of the usufruct for a consideration; and, finally, (4) *'arīyah* (loan), the transfer of the usufruct without consideration.[236]

Despite their chief importance as foundational contracts, a much greater number of contracts constitute 'exceptions' to the basic scheme. The ulema cite, as "standard practice", that by strict analogy or *qiyās* with the relevant prototype contract, these exceptions would be invalid; in other words, their *'illah* would not correspond with the prototype contract. This is the case with exceptional contracts such as *istiṣnā'* and *salam* that are examined below; it also applies to *bay' al-wafā'* – a financing contract in which a house or land parcel is sold for a cash price with the condition that the seller can repurchase the house at a later date. Agricultural tenancies and commercial ventures such as the *muzāra'ah*, and, most importantly, for modern Islamic banking transactions, the *muḍārabah*, are all seen as exceptions to the relevant prototype contracts.[237] As a rule of thumb, all contracts for which a consideration as a fixed percentage of the profits is determined as a condition to the contract fall into this latter category.

---

[236] Ibid., 19.

[237] Ibid.

Although such contracts did not meet the rigid standards of Islamic legal theory, classical jurists came to regard 'exceptional' contracts as "vital and integral parts of the total system".[238] In fact, these exceptions far outnumbered the foundational structures.[239]

3.4 THE CONDITIONS NECESSARY FOR THE GENERAL VALIDITY OF CONTRACTS

The Islamic contract of sale contains three critical cornerstones or factors that apply to all other contracts. These include the seller, the buyer, the form (*ṣīghah*) and the object of the contract.[240] Jurists disagree whether it is necessary to combine all of these elements as a matter of principle. In all contracts, however, jurists agree that the form of the contract must include an acceptance (*qabūl*) and corresponding offer (*ījāb*).[241] Further, a sale is valid if its fundamental components (*arkān*) and ancillary attributes (*waṣfs*) are legal and are not connected to a third party. Moreover, a valid sale must not contain options. Properly concluded, a valid sale commences the immediate exchange of ownership of the object of sale and the price. Therefore, a sale without options would transfer immediate ownership of the object of sale to the buyer and the price to the seller.[242]

---

[238] Ibid., 29.

[239] Ibid., 28-29.

[240] Hallaq, *"Sharia" (2010),* 240.

[241] Al-Zuhayli, "*Transactions"* (2003), 22.

[242] Ibid., 72-73.

The legal status of a contract is either valid or invalid as a result of the degree to which the cornerstones and conditions of the contract are satisfied. A valid (*ṣaḥīḥ*) contract satisfies all of its conditions and cornerstones while an invalid (*bāṭil*) contract violates one or more of its conditions and cornerstones. A sale is invalid if it is defective (*fāsid*). However, the Ḥanafīs categorise contracts according to three criteria: namely, (1) valid (2) defective and (3) invalid. Therefore, they distinguish between contracts that are not valid, i.e. between those that are defective and those that are invalid. A forbidden contract, although sinful, could be engaged in without invalidating the contract. Thus Ḥanafīs differentiated between the fundamental components (*arkān)* of a contract, which invalidate it; and the prohibition of a general characteristic (*waṣf*) that only leads to it being defective.[243]

However, the majority of jurists ruled that a prohibited contract is invalid and that whoever utilises such a contract has committed a sin. Furthermore, the prohibition of a main component (*rukn*) of a contract "is equivalent to a prohibition of a general characteristic that is satisfied in that particular contract".[244] Any action, whether a fundamental component or a general characteristic, that disagrees with God's commands, is both defective and invalid.[245]

---

[243] Ibid., 71-72.

[244] Ibid., 71.

[245] Ibid., 72.

With respect to the form of a contract, the law's overriding concern is that the quality of *riḍā*, i.e. unconditional consent, is present between the parties. *Riḍā* can assume many forms.[246] With respect to contracts orally concluded, Muslim jurists regard the exchange of offer and acceptance not as an exchange of promises or even implied promises, but rather as performative utterances, that is, as oral statements that have legal effects. In keeping with the sacrosanct nature of the utterance, both offer and acceptance are generally to be expressed in the past tense to indicate finality, rather than in the future tense, which is promissory *('idah*).[247] The past-tense expression of the dispositive utterance reflects the contracting parties' establishment of immediate rights and obligations; so that the contract of sale is envisioned as an immediate transfer of counter-values.[248] However, the Ḥanafīs allow the exchange of offer and acceptance in the present tense as it indicates immediate or future action in the Arabic language.[249] An offer made in the present tense requires further clarification so that there is no uncertainty with respect to the way in which such language may be construed.[250]

With respect to the object or effects of the contract, a series of overarching principles must be satisfied which imply that every category of acts or contracts has an end it itself. Generally, the

---

[246] Hallaq, *"Sharia"* (2010), 240.

[247] Zysow, "Problem" (1985-1986), 75. The contract of marriage is exceptional in that it requires specific language, namely the utterance of "*zawwāja*" and "*nakaḥa*" (both meaning to marry).

[248] In the majority of contracts offer and acceptance must be exchanged in the same session (*majlis*). However, the *majlis* requirement does not mean that contracts cannot be concluded in written form. The acceptance of a written offer is deemed to be binding in the same manner as had the parties concluded the agreement in the *majlis*. See Hallaq, *"Sharia"* (2010), 243.

[249] Al-Zuhayli, *"Transactions"* (2003), 9.

[250] Hallaq, *"Sharia",* 242.

objective must be morally attainable, and accord with other religious requirements, otherwise it is declared illicit (*ḥarām*). In particular, the contract must be linked to the holy texts and the effects must necessarily conform to the principles of the sharia. Any transgression of these effects or the creation of new ones which do not conform to sharia principles is unlawful. For example, sale has been deemed permissible on the basis of supporting evidence from the Quran, the Sunna, and *ijmā'*.[251] The Quran is explicit on this matter: "But Allah has permitted trade"[252] and "But let there be among you traffic and trade by mutual good will".[253] The second criterion pertains to the determination of what the religion of Islam forbids. This list could comprise numerous illicit objects including the sale of alcohol, pork, *ribā* (usury), etc.[254]

Furthermore, several necessary conditions are attached to the object of contract for it to be valid. Most jurists agree that four principal requirements must be met: First, the object of the sale must be in existence. Thus the sale of a non-existent object or an object that may cease to exist is not permitted. Exceptions to this general rule are made for the contracts of *bay' al-salam* (a forward sale in which the price of a commodity is paid upfront) and *istiṣnā'* (the sale of a manufactured product/contract of hire, with payments made at varying stages). Second, the object of sale must be owned and must be temporarily non-perishable, i.e. available for future use or consumption. Third, the article of sale must be owned privately and be in the possession of the seller. This stipulation prevents the sale of publicly owned lands, waters, wildlife and so

---

[251] Al-Zuhayli, *"Transactions"* (2003), 6.

[252] Quran 2:275.

[253] Quran 4:29.

[254] Comair-Obeid, "*Contracts"* (1996), 16-17.

forth. Finally, the object of sale must be deliverable upon conclusion of the sale. Therefore, the sale of an undeliverable good may not be concluded.[255] The existence of counter-values in a contract of sale is given further consideration below.

3.5 APPENDING SHURŪṬ (CONDITIONS) TO CONTRACTS

As discussed above free will has a limited scope in the formation of the Islamic contract. Each nominate contract produces its own effects and the degree to which these may be modified or altered by appending special conditions (pl. *shurūṭ*, sg. *sharṭ*) illuminates the object of the present discussion. Despite the theological limitations that have been discussed, the religious scholars (*fuqahā'*) concede that parties are free to contract as they see fit as long as they do not add new effects to the contract or contravene the criteria with respect to the essence or finality of the act as established above.[256] Jurists perceive a danger in allowing parties to remove or, much less frequently, add effects to their contracts as these may create abuses which involve illicit profit or *ribāwi* (*ribā*-based) transactions. An imbalance of benefits amongst contracting parties may ensue that undermines the essential reciprocity of exchange and the principles of equity and justice which underpin the law. Jurists legitimate this ruling with the well-known Hadith from the Bukhārī compendium in which the Prophet expressed his opinion of the subject in front of his wife Aisha: "What do they think of, those men who lay down conditions not to be found in the Book of God? Any stipulation not to be found in the Book of God is null and void.

---

[255] Al-Zuhayli, *"Transactions"* (2003), 15-16.

[256] Comair-Obeid, "*Contracts"* (1996), 32.

Were there a hundred such conditions of this sort, the one rule of God will be more equitable and more sure".[257]

Of course, parties to a commercial transaction need to add stipulations or other conditions to a contract to fulfil commercial objectives. Recall that some modern jurists perceived a margin of freedom for doing so only in the formation of the option (*ikhtiyār)*. At the moment of the option parties may choose different modalities with respect to the execution of the contract as long as these do not offend the essence of its structure.[258] However, the positions of the schools of law with respect to these criteria differ as considered below.

3.5.1 CONDITIONS AND THE FOUR SCHOOLS OF LAW

Two general strands of thinking underlie the *madhhab* positions with respect to the appendage of ancillary conditions to an Islamic contract. The first is typified by the Ḥanafī position, which is almost identical in every point of detail to the Mālikī and Shāfiʿi viewpoint. Ḥanafīs categorise *shurūṭ* into two classes: (1) clauses which are valid or *ṣaḥīḥ*; and (2) clauses which are null and void (*bāti*). The following examines those conditions that do not conflict with the sharia. First, clauses which confirm the effects of contracts already established in the *fiqh* do not occasion controversy as no additional obligation is imposed on either party. An example would be for a seller to deliver a sale object to the buyer as this is an obligation that resides with the seller

---

[257] Ibid., 32-33.

[258] Ibid., 33.

whether explicitly mentioned or not. Second, Al-Kāsānī notes that clauses which establish effects that agree with the effects of acts to which they are attached, are also deemed valid. According to Ibn Qudāma, these are known as stipulations "connected with the legitimate interests of the parties". These include: a pledge; a security or bond in a sales transaction to secure payment;[259] the determination of the period over which payment is to be made; and specification of the quality of services to be performed. These stipulations are valid and binding.[260] Finally, many clauses are deemed lawful due to their customary usage or practice. These tend to be services of little import that a purchaser may require of a seller when conducting a transaction. This latter class of *shurūṭ* is seen as an exception and granted permissibility on the basis of *istiḥsān*. Al-Kāsānī explains that "according to *qiyās* the clauses are not valid because they involve a supplementary advantage for one of the contracting parties. They are null and void just like a clause by which the purchaser of some cloth required the seller to make him a shirt of it. But such clauses have been accepted in practice; the *qiyās* has given ground in the face of such practice and these stipulations have been admitted by *istiḥsān"*.[261] Notably, Shāfiʿis and Mālikīs admit the use of clauses that reflect customary commercial practice as a matter of principle.

As noted above, Ḥanbalīs take a decidedly more liberal view of the role of human will in the contracting process. (Unsurprisingly, Islamic finance often avails itself of the Ḥanbalī doctrine.)

---

[259] Ibid., 35-36.

[260] Coulson, *"Commercial Law"* (1984), 51.

[261] Comair-Obeid, *"Contracts"* (1996), 36.

Ḥanbalī liberalism extends beyond the sphere of the option even to the actual effects of the contract. Yet clauses and stipulations must not contravene general prohibitions or consensus (*ijmā'*). In fact, few new contracts are able to avoid this legal web.[262] Still, the general sentiment is that parties are able to contract according to their requirements. The influential Ḥanbalī jurist, Ibn Taymīyah, went so far as to state that "the parties decide as they wish the content of their juridical acts and determine the effects on the condition that these effects are not contrary to public order and morals".[263]

The Ḥanbalī *madhhab* adopted several areas of overlapping restrictions with other schools which bear mention because of Ḥanbalī doctrinal prominence in the LIF. First, as is the case with the Ḥanafīs, Shāfi'is and Mālikīs, a single contract may not comprise two agreements or stipulate a condition, the fulfilment of which is necessary to enact the other. A famous dictum from the Prophet declared that "a loan coupled with a sale is not lawful".[264] This prohibition is ostensibly designed to avoid the uncertainty surrounding the apportionment of consideration or price. Therefore, the sharia forbids the creation of two contracts for a single price. This is a significant problem for Islamic financial transactions since they combine nominate contracts and wholly novel legal structures to achieve a single financial objective. The solution has been to create 'promise to purchase/sale' undertakings, which enables individual contracts to be transacted separately. This strategy is examined in detail in chapter five.

---

[262] Vogel and Hayes, *"Islamic Law"* (1998), 99.

[263] Comair-Obeid, *"Contracts" (1996),* 38.

[264] Coulson, *"Commercial Law"* (1984), 54.

Second, a contract of sale may not impose two ancillary conditions imposing supplementary obligations upon the same contracting party. So, for example, a buyer who purchased corn or wheat and required the seller to both grind and deliver the commodity to him would be unlawful. Finally, conditions may not be imposed that run counter to the juridical purpose of the act to which they are attached.[265] For instance, a seller could not forbid a buyer from disposing of his property as he wishes and so forth. While these rules place restrictions upon the contracting parties' liberty to contract to some extent, particularly as seen in the modern sense of the concept, the Ḥanbalī position is nonetheless relatively unencumbered as compared to other *madhhabs.*

The Ḥanbalī stance on contractual liberty is supported with textual evidence from the Quran which, as noted, includes exhortations to fulfil one's contracts. From these verses Ḥanbalīs deduce that every contract or condition which God has not declared *ḥarām* is licit in the absence of any divine textual references that speak otherwise.[266] Hence, the Ḥanbalī position clearly views a larger role for human will in choosing the effects and conditions of contracts. There is a presumption of permissibility (*ibāhah*) in transactions because 'nothing in them is forbidden,' as Ibn Taymīyah enunciated. According to Ḥanbalī jurists, an attempt to declare something forbidden on merely speculative grounds, or to impose hardship or unnecessary rigidity upon

---

[265] Ibid., 39.

[266] Musa, "Liberty" (1955), 84.

people, violates the spirit of tolerance and well-being that God wishes for His believers.[267] The following Quranic verse is cited as proof: “God desires for you ease, He does not desire for you difficulty”.[268] Every people and epoch develops customary manners of business practice for which it would impose hardship were people required to provide direct textual support (*naṣṣ*) from the Quran or Sunna to vindicate the legality of every commercial exchange.[269]

3.6 GHARAR

The complex regime of Islamic contracts is subject to additional rules that have wide-reaching effects. The following examination begins with the prohibition of *gharar.* The prohibition of *gharar* (excessive risk, uncertainty, or speculation) is concerned with the issue of the existence of the counter-values at the time of contract; their qualities, quantities, ownership, and presence.[270] Islamic law is averse to transactions which blindly award one person’s good fortune at the expense of another’s bad luck. It is considered an unjust result for which the *fuqahā’* sought to devise a systematic principle that required equality and fairness between the transacting parties in the formulation of contract. A just profit should be the result of one’s labour, time and expenditure.[271]

---

[267] Kamali, “Commercial Law” (2000), 67-69.

[268] Quran 2: 185.

[269] Al-Amine, "Istisna'" (2001), 27.

[270] Some authoritative works on the subject are: Comair-Obeid, “*Contracts”* (1996); Saleh, “*Unlawful Gain”* (1986); and Hidayat, “*Contracts”* (2000).

[271] Hassan, “Contracts” (2002), 280.

Aleatory contracts, both pre-modern and contemporary, consist of financial products which seem to typify the probabilistic inequality which the jurists so vehemently opposed. These contracts entail an uncertain outcome for one of the transacting parties whose benefit or loss from the transaction is impossible to predict. Parties to an aleatory contract stipulate the possibility of gain or else they seek to insure themselves against loss as a result of some unforeseeable circumstance. Yet gains and losses are not calculable beforehand as a result of this uncertainty. Thus the element of uncertainty on which these contracts rest necessarily results in the benefit of one party at the expense of another's loss.[272] Nonetheless, jurisprudence ceded ground to the necessities of commerce in numerous instances, which resulted in a philosophical rendering of exceptions and qualifications to the general prohibition. These differed according to the jurist's *madhhab*, and the context and time of his writing.

The prohibition of *gharar* has widened in scope and detail over the centuries. The Quran warns humans to take care with regard to their own folly and extravagance, which may interfere with the believers' ritual and worship. Games of hazard or gambling (*maysir*) – a favourite pastime of pre-Islamic Arabs – are proscribed: "You who believe, intoxicants and gambling, idolatrous practices, and [(divining with) – a pagan Arab custom] arrows are repugnant acts – Satan's

---

[272] Comair-Obeid, *"Contracts"* (1996), 55. For a very interesting analysis in which the author has applied game theory to the concept of *gharar*, see al-Suwailem, "Gharar" (2000). Al-Suwailem explains that the Quranic concept of *gharar* was to prevent enmity by prohibiting outcomes in which one party wins everything (zero-sum) at the expense of the other party.

doing – shun them so that you may prosper".[273] These foundational verses do not specifically mention *gharar* but provide a general idea/principle that is subsequently broadened and elaborated in the Sunna.

3.6.1 THE SALE OF A NON-EXISTENT OBJECT

Ibn Ḥanbal, eponym of the Ḥanbalī *madhhab*, relates a well known tradition that typifies the attributes of the prohibition. One should "not buy fish in the sea, for it is *gharar",*[274] i.e. because one does not know with certainty what one is buying. Moreover, Ibn Māja's recounting of the following Hadith continues to shape the concept of *gharar,* despite an acknowledged weak chain of transmission (*isnād*). He recites, "The Prophet forbade sale of what is in the wombs, sale of the contents of the udders, sale of a slave when he has run away, … and [sale of the] 'stroke of the diver' [*ḍarbat al-ghā'is*, sale in advance of the yield of a diver's dive, whatever it was]".[275] The message of these Hadiths, according to Muslim scholars, is to protect the weak against exploitation by the strong. The general rule is that any transaction devoid of uncertainty and speculation facilitates the parties' complete and perfect knowledge of the counter-values to be exchanged.[276]

---

[273] Quran 5: 90 and 2:219.

[274] Vogel and Hayes, *"Islamic Law"* (1998), 88.

[275] Ibid.

[276] Saleh, *"Unlawful Gain"* (1986), 62-63.

Ibn Rushd, a Mālikī scholar, wrote in his *Bidāyat al-mujtahid* that *gharar* in sale transactions causes the buyer to suffer damage as a result of a want of knowledge (*jahl*), which affects either the price or the object of purchase. He specified several conditions that must be met for *gharar* to be averted: (1) both the price and the subject-matter must be in existence; (2) the characteristics of these must be known; (3) their amount must be determined; (4) the parties must have control over these factors so as to ensure that the transaction can take place; (5) and, finally, the date of future performance, if any, must be defined.[277]

Subject-matters which are non-existent at the time a bilateral transaction takes place have been declared void by an overwhelming majority of traditional Muslim scholars.[278] A non-existent (*ma'dum*) subject-matter epitomises the risk and speculation of a transaction based on a want of knowledge, and the eventual qualities and condition a subject-matter may possess. A non-existent subject matter in contractual relations is often equated with debt (*dayn*). Yet the meaning of *dayn* is more general in that it relates to something not present, which is yet to be paid or completed at a future date; but which is already owned by the creditor pursuant to the contract. While a *dayn* is not yet in the possession of the creditor, it resides in his consciousness (*dhimmah*). Therefore, despite its incorporeal nature, *dayn* is described metaphorically in physical terms, leading some contemporary scholars to equate it with the English common law concept of "chose in action", or a thing not in possession of the creditor.[279]

---

[277] Ibid., 65.

[278] Ibid; Kamali, "*Commercial Law*" (2000), 99-102 . And Al-Zuhayli, *"Transactions"* (2003), 74.

[279] Foster, "Transfer" (2000-2001), 41.

3.6.2 THE SALE OF DEBT (BAY‘ AL-DAYN)

Consensus surrounds the opinion that the sale of a debt for another debt at a discount (*bay‘ al-dayn bi al-dayn*) is not valid since it results in *ribā*.[280] The right to payment was considered to be money (a *ribāwi* good) and thus constitutes a *dayn* in the *dhimmah* of the debtor. Money cannot be traded except at par value or else it violates the rules pertaining to *ribā al-faḍl* and *gharar*. An oft-cited Hadith supported this prohibition: “The Messenger of God forbade sale of the delayed obligation [*al-kali*’] for a delayed obligation”.[281]

The transfer of a debt from one debtor to another (*ḥawālah*) at par value could be undertaken subject to a number of strict rules that ensure *ribā al-faḍl* and *gharar* are not violated. Suppose that X (a transferee) owes a debt to Y (transferor) and Y owes a debt to Z (creditor). By transferring Y’s right to payment to Z, Y is freed from his obligation and Z has a right against X. Different rules pertain to the schools of law including who requires consent, whether or not a pre-existing debt owing to the transferor from the transferee is required, and to whom the creditor has recourse in case the transferee is unable to pay.[282]

The LIF also prohibits the sale of a debt at a discount to third parties, although there is controversy whether certain modern proprietary rights such as patents and copyrights, should

---

[280] Al-Zuhayli, *“Transactions”* (2003), 81.

[281] C.f. Foster, "Transfer” (2000-2001), 43.

[282] Ray, "Medieval” (1997), 61.

be considered as dependent on corporeal matter (*'ayn*) or whether they should be seen as incorporeal rights in the *dhimmah* of the debtor.[283] In the former case the transfer of such rights could be exchanged with a profit while the latter require equivalence according to the rules of *ribā al-faḍl.* These are considered below.

3.6.3 GHARAR AND THE FOUR SCHOOLS OF LAW

Many prominent scholars qualified their objections to *gharar* transactions. Ibn Rushd wrote that in case of necessity (*ḍarūrah*), and when the future existence of the subject-matter is certain, a sale contract could be valid. For example, a sale contract involving the harvest of fruit prior to full ripening was permitted by the Mālikīs as long as such fruit can be harvested in continuing succession. The majority opinion proscribed the sale of fruit prior to its full ripening.[284]

Ibn Rushd skilfully pointed out that each school of law's position with respect to a contract of sale for an absent thing or object (*bay' ghā'ib)* was unique and certainly not homogeneous. In a *bay' ghā'ib* the vendor has title over the subject-matter, but the subject-matter is either not available or not present at the meeting of the parties. Historically, the *bay' ghā'ib* served an important role in regional and long-distance trading in the far-flung Islamic provinces, as needed commodities were imported from trading partners without the buyer having inspected the goods

---

[283] Shaukat, "Debt" (2010), 9-10.

[284] Ibn Rushd, "*Primer"* (1994-1996), 182.

prior to their importation.[285] Al-Malik and his disciples permitted the sale of an absent commodity so long as it was accompanied by description and was of the nature or kind of good whose essence did not alter prior to the buyer taking possession. If the object conformed to the description, the sale became binding. On the other hand, Al-Shāfiʿi and his disciples prohibited the *bayʿ ghāʾib* due to the buyer's failure to inspect the goods prior to purchase. Whether the unavailable object was accompanied by description or not was immaterial to their reasoning.[286]

The Ḥanafīs deemed the transaction valid by requiring the vendor to indicate the location of the good and by describing the object in detail. Known as the *khiyār al-ruʾyah* (the option of inspection), it entitled the purchaser to inspect the subject-matter after the purchase whereupon he could decide to proceed with or rescind the sale. Likewise, the Ḥanafīs held that the buyer always had a right to *khiyār al-ruʾyah* – even when the subject-matter mirrors the seller's description – and were thus more lenient with respect to *bayʿ ghāʾib*.[287] The point of contention concerned the issue of whether the degree of knowledge gained through description of the sale-object is equal to that gained by one's sensory perception of an object at-hand.[288] Thus the eponyms of the schools debated whether the degree of uncertainty (*gharar*) in a given transaction was permissible or not.

---

[285] Saleh, *"Unlawful Gain"* (1986), 85-89.

[286] Ibn Rushd, *"Primer"* (1994-1996), 187-88.

[287] Ibid.

[288] Ibid., 188.

According to al-Nawawī, Shāfi'is tolerated *gharar* in case of need and when *gharar* could only be averted with exceptional difficulty.[289] Ibn Taymīyah argued vehemently that the sale of a non-existent object is unlawful only if it involves gambling and the misappropriation of the property of others, as there is neither a textual ruling (*naṣṣ*), nor a general consensus to support the view that such a sale is unlawful.[290] His disciple, Ibn Qayyim al-Jawzīyah, defended his mentor's argument by asserting that no reference, either specific or general, exists in the Quran or the *Sunna* of the Prophet or his companions to the effect that the sale of something non-existent is unlawful. The essential feature of sale is the delivery of the item sold; if the seller is unable to deliver, then this is the risk and speculation – the gambling – of which the Quran clearly speaks.[291] These scholars seem to have recognised early on that the tendency to define *gharar* in terms of non-existence of the subject-matter had become deeply entrenched, and had outgrown the early substance of the principle as depicted in the Quran, i.e. risk, speculation and uncertainty associated with gambling. The concept of *gharar* had evolved by virtue of *qiyās* into a question of the existence of the subject-matter in a contract of sale.

The contemporary Lebanese jurist, Maḥmaṣānī, qualifies the general requirement of existence of the subject-matter by making a distinction between the subject-matter as a specific piece of property (*'ayn*) and the subject-matter in the form of labour *('amal*) or use (*manfa'ah*). The subject-matter as an *'ayn* must meet the requirements as discussed above; whereas subject-

---

[289] Saleh, *"Unlawful Gain"* (1986), 67.

[290] Kamali, "Commercial Law" (2000), 100.

[291] Ibid., 101.

matters in the form of labour and use are necessarily non-existent at the time of contract and only come into being with the gradual implementation of the contract.[292] A lease contract (*'ijārah*), for instance, in which the usufruct of an object is hired for a specific term, only materialises with usage over a period of time. A contract of manufacture (*istiṣnā'*), in which a specialist's labour is employed to produce a subject-matter, is included amongst these exceptions. Other kinds of transactions such as a guarantee of debts (*kafālah*) or agency (*wakālah*), which also involve use, are equally applicable to this distinction.[293] Accordingly, a majority of scholars made exceptions for these types of contracts, if only on a case-by-case basis,[294] and with reference to principles such as *istiḥsān*, and subsequently, *ijmā'*.

3.6.4 AVOIDING THE RIGIDITIES OF GHARAR

In practice the exigencies of trade and commerce required the *fuqahā'* to find solutions to the rigidity of the *gharar* prescription. *Ḥiyal* were employed to enable transactions that had appreciable benefits for the people. These included cases in which the value of the commodity was not precisely known, as in *muzabana* contracts,[295] or in the barter of livestock for meat, which on the basis of its unknown differences in counter-values would violate both the prohibition of *ribā* and *gharar*. In sum, Islamic jurisprudence has yielded over time to the

---

[292] Saleh, *"Unlawful Gain"* (1986), 69.

[293] Ibid.

[294] Kamali, "Commercial Law" (2000), 100.

[295] Rayner, "*Contracts"* (1991), 291.

pressures of commerce and the needs of human existence, shielding merchants and traders from the sin of *ribā* and *gharar* by formulating exceptions to rules.

Most, if not all, commercial transactions, including those which took place in the early Islamic period, contain a certain element of risk or uncertainty with regard to some attribute of the transaction. In the classical period jurists seem to have agreed that excessive *gharar* (*al-gharar al-kathīr*) was prohibited whereas minimal *gharar* (*al-gharar al-yasīr*) was not. However, they continued to disagree about what constituted these categorisations.[296] Several modern jurists sought to establish a sort of doctrine of *gharar* that establishes legal effects and creates a viable framework for the assumption of risk. Maḥmaṣānī, for example, differentiated between excessive and trivial *gharar* with respect to legal effects. Excessive *gharar* renders a contract null and void (*bāṭil*), or it may be cause for indemnity and compensation. Slight *gharar* may be deemed to be tolerable (*mubah*) and, if so, would not invalidate a given transaction.[297] Al-Sanhūrī advocated that a distinction should be made between instances in which the subject-matter of a transaction is non-existent but will come into existence with certainty, and other cases in which the subject-matter is also non-existent, but the probability involving its existence is uncertain – thus invoking *gharar*. He accepted the notion of a scale of *gharar* in which excessive *gharar* is outlawed and slight *gharar* in which the transaction is valid.[298]

---

[296] Ibn Rushd, "*Primer"* (1994-1996), 186.

[297] Kamali, "Commercial Law" (2000), 85-89.

[298] Saleh, *"Unlawful Gain"* (1986), 68.

Both scholars clearly recognised the necessity of aleatory contracts in modern commerce and thus stressed the degree of *gharar*. Their position diverges from the classical one by qualifying the prohibition on the basis of the non-existence of the subject-matter. The following section addresses the second major prohibition in the law of Islamic contracts, namely, the prohibition of *ribā*.

3.7 THE PROHIBITION OF INTEREST: RIBĀ

The practice of forbidding interest took place as early as 1750 BCE, if not earlier. King Bocchoris of the Egyptian 24th Dynasty (730-715 BCE) forbade the receipt of interest in excess of the principal amount owed. And the great Egyptian jurist, al-Sanhūrī pointed out the significance of the moment when Egypt decreed – after a three thousand year hiatus – that modern Egypt should adopt the same rule in Article 232 of the Civil Code.[299] However, the levying of interest is equally ancient and likely a more prevalent form of money-lending. Ancient Greeks and Romans charged exorbitant interest with the peculiar aspect of securing debt in the form of the person. If a debtor was unable to repay the loan in kind, he became the creditor's slave. In Rome, slavery for debt existed well into the fourth century CE.[300]

At the inception of Islam money was generally hoarded, for it was regarded as unproductive in the sense that a money economy did not yet fully exist. In its place Meccans are to have

---

[299] Saleh, *"Unlawful Gain"* (1986), 12.

[300] Ibid., 68.

bartered commodities in Syria with the objective of returning to Mecca laden with other more precious goods from settled agriculturalist societies. Goods transported and sold in Syria were hides, leather goods, skins, clothing and perhaps also animals, clarified butter, and perfume, on occasion.[301] Workers did not receive money-wages for their labour, and production was not the chief focus of hoarded wealth.[302]

Goitein's meticulous scholarship of the *Geniza* records shows that gold and silver were still traded as commodities three centuries later. However, by then they were also widely used as means of payment.[303] At each transaction, coins, like goods, had to be weighed and their value, including their fineness and state of preservation, had to be determined. Money was generally handled in sealed purses of coins whose value was attached to the outer purse. A similar system prevailed in Roman and Jewish societies, and, subsequently in Christian Europe.[304]

So-called 'merchant bankers' (the "*tājir")* in the "*dār al-ṣarf*" (the money exchange of Fustat) were highly adept at handling money. As a rule, merchant-banker accounts indicated the real value or the value in weight of the dinars in consideration. Therefore, a document indicates that a purse of 76 and 1/6 dinars most probably contained 80 gold pieces.[305] The prohibition of *ribā*

---

[301] Crone, "*Roman"* (1987), 149.

[302] Haque, "*Ribā "* (1985), 95.

[303] Goitein, "Geniza" (1955), 82.

[304] Goitein, "*Mediterranean"* (1967), 231.

[305] Ibid., 231: 239.

al-faḍl (*ribā* by excess) – examined below – is more easily understood in light of these circumstances.

3.7.1 THE ISLAMIC ORIGINS OF THE PROHIBITION OF RIBĀ

In the Muslim tradition the prohibition of *ribā* is a central factor affecting all obligations and contracts in Islamic law due to its influence on the shape and contours of all commercial activity. *Ribā* has been simply defined to convey an unjustified enrichment in which a party receives a monetary advantage without giving a counter-value in return.[306] Yet scarcely is there a principle the meaning of which has been as vehemently contested over centuries of commercial practice and jurisprudential thought.

The Arabic root of *ribā* is *r.b.w.*, which denotes increase, to grow or to augment. It is used twenty times in the Quran. As a noun *ribā* denotes excess (*ziyādah*), increase, augmentation, expansion or growth (*namā*), which for its part is used eight times in the Quran.[307] A consensus that the general meaning of *ribā* is synonymous with 'increase' is one of the few areas where there is little or no controversy.

The prohibition of *ribā* in classical Islamic law seems to have developed gradually in successive revelations, likely beginning with the Meccan revelation from the *sūra al-rum* (references the

---

[306] Schacht, "*Introduction"* (1964), 145.

[307] Saeed, "*Interest"* (1996), 2: 20.

defeat of the Byzantines at the hands of the Persians (613-614 CE)) which declares: “That which ye provide with the prospect of an increase through the property of [other] people, will have no increase with Allah; but that which ye provide for charity, seeking the countenance of God, [will increase]: it is these who will get a recompense multiplied”.[308] The Meccan verses are replete with denunciations of the economic injustices of Meccan society such as widespread profiteering and commercial exploitation by a small group of wealthy patricians at the expense of the poor.[309]

Tradition indicates that a debtor who could not repay the capital (money or goods) with accumulated interest at the time it came due was allowed an extension on the condition that the sum was “doubled and multiplied” – *aḍ‘afan muḍā ‘afatan*. In his *Muwatta’*, al-Mālik Ibn Anas (d. 179/795-6) recites this loan-*ribā* tradition, as follows: “Zayd ibn Aṣlam relates that the *ribā* of *jāhilīyah* (pre-Islamic times) was that the creditor, who had given a loan for a certain period to a debtor, used to demand from the other when the time for its repayment came (saying): “Will you return the loan, or give an increase (over the loaned capital)”?[310]

The custom of doubling one’s debts was categorised by some authors, including the renowned Ḥanbalī scholar, Ibn Qayyim al-Jawzīyah, as a so-called third category of *ribā* known as *ribā al-*

---

[308] Quran 30:39.

[309] Rahman, "Ribā ” (1964), 3.

[310] Haque, “*Ribā ”* (1985), 36.

jāhilīyah.[311] *Jāhilīyah* is a time of 'ignorance', as the successive revelations from God to his Prophet Muhammad had not yet transpired in the period before the rise of Islam. Al-Jawzīyah reported that Ahmad Ibn Ḥanbal confirmed that the *ribā al-jāhilīyah* was the *ribā* as to which there was no doubt. For his part, al-Jawzīyah considered this "manifest *ribā*" and noted that besides this there are many unfair forms of commercial practice which are not explicitly *ribā*, but which he labelled as "concealed *ribā*". The breadth and range of the term was confirmed by the great expert on Hadith, Ibn Ḥajar al-'Asqalānī, who said that "the term *ribā* can be applied to every forbidden commercial practice".[312]

Many authors have contended that the Quran testifies to an increasing awareness of the division between rich and poor and a diminished social morality vis-à-vis the poor and orphans.[313] Moreover, the Quranic stress on acts of generosity seems to imply that this value had eroded to some extent in early Islamic society. Yet charges of excessive wealth and diminished moral values are the standard repertoire of monotheistic preachers and, while the book is revered as the word of God for all devout Muslims, it cannot be adduced as evidence of the social conditions in pre-Islamic Arabia.[314] A well-known theme indicates that the good things of this world divert men's hearts from God and expose one to the danger of sin. Thus, the

---

[311] Schacht, "Ribā " (1936).

[312] Rahman, "Interest" (1964), 36.

[313] See, for example, Watt, "*Muhammad"* (1953).

[314] Crone, "*Trade"* (1987), 232.

burden of guilt is placed upon the well-to-do. This notion has become inextricably linked with the sentiment that the wealthy and powerful are unjust and oppressive.[315]

While the Quran, especially in the early Meccan period, contains verses which rise up and rail against riches and the rich, it is equally evident that there is nothing in the Quran and the Sunna against trading and profit-making. In fact, the Quran has been described as the embodiment of the relations between man and God of a "strictly commercial nature". Allah is the merchant and the universe his reckoning, where all is counted and everything measured. His institution is the Quran and He establishes a pattern of honest dealing. Life is a business in which man gains or loses.[316] Furthermore, a number of traditions attest to the merchant's exalted role in the afterlife, such as Muhammad's proclamation that: "the merchant who is sincere and trustworthy will (at Judgment Day) be among the prophets, the just and the martyrs".[317] In fact, before his prophetic mission, Muhammad was a successful trader in his own right. In sum, the lack of historical evidence from the early origins of Islam leaves us unsure as to the socio-economic roots of the prohibition of *ribā*; evidence that, were it available, might provide contextual clues as to the intended meaning of *ribā*.

Nonetheless, the practice of doubling the principal sum of a debtor in the event that the debtor was unable to pay is widely corroborated by numerous Muslim narrators, including the Quran.

---

[315] Rodinson, "*Islam"* (1974), 24.

[316] Torrey, "Commercial-Theological" (1892), 48.

[317](Darimi, Sunan XVIII, 8) c.f. Rodinson, "*Islam"* (1974), 16.

Therefore, it must be accepted as historically persuasive. The usurious practice is illuminating in the sense that it stands in stark contrast to the Quran's clear message of social responsibility and mutuality in which the wealthy have a moral obligation to provide for the poor, the needy, widows, the divorced, slaves and the generally less fortunate. It is clear that the Quran's revolutionary appeal consisted not only in the spirituality of its message but also in its zeal for altering embedded social practices that it deemed corrosive and immoral.

Undoubtedly, the Quraysh's[318] zeal for exorbitant profit-making is admonished in two separate passages in the Quran that deal specifically with this practice.[319] Quran 3:130 is thought to be an early Medinan passage, which would thus have been revealed after Muhammad and his followers' emigration (*hijra*) from Mecca and the subsequent Muslim defeat at the battle of Uḥud.[320] The verse, from the *sūra āl 'Imrān* – the family of 'Imrān – is sharper in its admonition against the consumption of *ribā*, perhaps reflective of the Muslim community's increased political stature. Muhammad commands: "You who believe, do not consume usurious interest, doubled and redoubled. Be mindful of God so that you may prosper – beware of the Fire prepared for those who ignore [Him] – and obey God and the Prophet so that you may be given mercy".[321] The revelation is no longer a recommendation but a command and warning to the

---

[318] The Quraysh were an affluent and powerful Meccan tribe that controlled access to the Kaaba, the most sacred site of Islam. The building predates Islam and at one time was the object of polytheistic worship. Muslims now turn to the Kaaba in prayer, five times a day; prayer is considered to be a pillar of Islam.

[319] (Quran 3:130 and 30:39)

[320] Saeed, "*Interest"* (1996), 2: 21-22.

[321] (Quran 3:130)

believers to desist in usurious lending typified by doubling the principals of the debtor's debt. Some Western scholars, including Schacht and Rodinson, associate this gradualism with Muhammad's experience with money-lending as practised by the Medinan Jews after the *hijra*, but this assertion has not been substantiated.[322]

The third and last *sūra*, *sūra al-baqarah* or the cow, revealed before the fifth year of the *hijra* and the exile of the last Jewish tribe of *banū* Qurayzah, delineates the seriousness of the prohibition further: "Those who devour *ribā* shall only rise again as one whom Satan strikes with his touch; this because they say, 'selling is like usury'; but Allah has permitted selling and forbidden usury. He therefore who receives a warning from his Lord and abstains shall have pardon for what is past and his affair is with Allah; but they who relapse into usury are the people of Hell, and they shall remain in it forever. Allah abolishes usury and makes alms bring interest; Allah loveth no sinful unbeliever [...]".[323] The Quran is adamant that those who disregard the ban on *ribā* merit the hell fires of the afterlife; these unbelievers (*kuffār*) commit perhaps the gravest sin that one may commit – it was said to have been worse than murder, idolatry and incest.[324] Yet this passage is also important for its depiction of sin, on the one hand, and righteous deeds, on the other. The last verses speak of God's desire that the creditor allow a delay in payment of the debt, should circumstances require it, or absolving the debtor from his

---

[322] Schacht, "Ribā " (1936).; Rodinson, "*Islam"* (1974), 15.

[323] (Quran 2:275-81)

[324] Juynboll, "*Handbuch"* (1910), 270.

obligation altogether. This message has had important consequences for how Islamic financial institutions treat late payments or payments in default.

The above verses constitute the essence of the traditionalist *'fiqhī'* (jurisprudential) interpretation of *ribā.* Jurists viewed them as a denunciation of the rich money-lender, who receives an increase in the form of usurious *interest* without giving to the other party, a borrower who is likely less well-off, an equivalent return. Unearned income absent an equivalent measure of productive economic activity is viewed as the root of injustice and commercial exploitation. It tends to enrich the moneylenders and usurers and impoverishes those who must borrow to meet their basic existential needs.

3.7.2 THE DIFFERENTIATION OF THE RIBĀ CONCEPT: MONEY, TIME AND COMMODITIES

Available historical documents indicate that *ribā* as enunciated in the Quran, in the earliest period of Islam, was most likely understood to prohibit interest on loans, chiefly in money and foodstuffs. This fact is attested by numerous documents from the *Geniza* indicating that not only were loans without interest extended on the basis of kinship or partnership but documentation completely failed to mention any increase for such acts despite the intricacy and detail of such records.[325] In fact, few documents openly describe lending practices with interest, although the taking of loans on interest from Muslims and vice versa was regarded as legal,

---

[325] Goitein, "*Mediterranean"* (1967), 254.

despite Islamic law's clear statements as to its unlawfulness. The main point here, however, is that dealing in 'interest' was equated with the trespassing of God's law; whether or not it was, in fact, the *ribā* of which the Quran speaks, is less important than the way in which Muslims, and Jews for that matter, understood the scriptural sources.

A strongly influential tradition is cited from the Hadith specialist, al-Muslim, whose collection is regarded as amongst the most authoritative of the Hadith collections. The Hadith extended the prohibition considerably to the exchange of currencies and several critical foodstuffs. These became property susceptible of *ribā* (*mal ribāwi*). It declared: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, hand to hand. If these types differ, then sell them as you wish, if it is hand to hand". Versions of this Hadith exist in all the major *ṣaḥīḥ* (valid) compilations.[326] The majority of jurists of the schools of law agreed that although the items mentioned in the Hadith are very particular, its meaning could be extended to other goods; however, jurists disagreed about the general underlying meaning on the basis of which these species were prohibited – the *'illah* of the prohibition.[327]

From this Hadith and others a more technical systematisation of *ribā* developed in which unlawful gain is expressed in two forms. The first is *ribā al-faḍl*. It is "derived from the quantitative inequality of the counter-values in any transaction purporting to effect the exchange

---

[326] c.f. Rayner, *"Contracts"* (1991), 271. See, for example, Khan, "Al-Bukhari" (n.d.), 211-12.
[327] Ibn Rushd, "Primer" (1994-1996), 159.

of two or more species, and which belong to the same genus and are governed by the same efficient cause".[328] The second, *ribā al-nasī'a* (*ribā* of delay), is the "deferred completion of the exchange of such species, or even of species which belong to different genera but are governed by the same *'illah* [...] whether or not the deferment is accompanied by an increase in any one of the exchanged counter-values".[329]

This Hadith – which forms the basis of this particular prohibition – applies principally to the two precious metals (gold and silver) and the four basic commodities (wheat, barley, dates and salt) mentioned in the famous tradition. By analogy these prohibitions were extended to all species which are governed by the same *'illah*; or jointly belong to any one of the genera to which the six articles named in the Hadith are subordinated. Saleh's definition of genus (*jins*) with respect to the *ribā* prohibition comprises a class of articles in which several subordinate classes or species are extant. Likewise, species may be defined as a group of articles which contain several common attributes or qualities, and, for their part, are subsumed under the broader category of genus. Consonant with most aspects of Islamic law, the schools of law offer diverse interpretations of the nature and specificities of genera.[330]

It is hardly surprising, then, that the four schools of law in Sunni Islam define the 'illah of the famous commodities Hadith differently. Shāfi'is detect two causes – that of currency and food;

---

[328] Saleh, *"Unlawful Gain"* (1986), 17.

[329] Ibid.

[330] Ibid.

Mālikīs expand upon the traits of food – those foods being basic foodstuffs or essential nutrients and others which are able to be preserved and stored; the Ḥanbalī and Ḥanafī schools see only goods sold by weight or by volume, which are subdivided into 3 classes: (1) measure by weight; (2) measure by volume (3) and highly precise measure (for gold and silver only). In particular, the Ḥanafīs stressed equivalence as the aim of prohibiting *ribā* as justice demands that transactions are fair and equitable. When the differing nature of things made the determination of equivalence difficult, if not impossible, a money system of dinars and dirhams was established for the assessment of their values. Things differing in nature should be related to each other proportionately – that is, the ratio of the price of an object with respect to its own genus should be equivalent to the ratio of the price of another object relative to its genus.[331] Fairness and justice are the end-result. All schools of law are unanimous that the *ribā* prohibition applies to goods that share a single subdivided class,[332] e.g. by weight, by volume, or by precise measure. Importantly, all the various eponyms of the schools of law based their rulings on different Hadiths, and sometimes, like Al-Malik, sought to reconcile two Hadiths to express a certain principle.[333]

---

[331] Ibn Rushd, "Primer" (1994-1996), 162; El-Gamal, "Ribā " (2001). El-Gamal believes that the prohibition – when seen from this viewpoint - emphasises the efficiency of trading rather than exploitation by the rich. In other words, by "marking to market" the goods and services to be exchanged, parties are able to maximise their respective utilities.

[332] Vogel and Hayes, *"Islamic Law"* (1998), 72-75.

[333] Ibn Rushd, "Primer" (1994-1996), 165.

The lack of functionality inherent in this type of reasoning is exemplified by the Ḥanafī *madhhab.* As noted, the Ḥanafī *'illah* has two characteristics: the circumstance in which exchanged articles belong to the same genus and the fact that the same articles are either measured or weighed as a function of the exchange. In the case that one of these two characteristics arises in the course of a transaction, i.e. evincing properties susceptible to the *ribā* prohibition, the counter-values must be exchanged on the spot and without delay. Gain or profit from the exchange is permissible only in a hand-to-hand transaction.[334] If the articles to be exchanged are either both measurable or both weighable and belong to the same genus, i.e. both characteristics of the *'illah*, a deferred transaction is strictly prohibited as is gain in the spot-exchange. When one of the exchanged counter-values is measurable and the other is not or when one of the exchanged counter-values is weighable and the other is not, gain is permissible in either a spot-sale or deferred transaction. Yet this reasoning leads to an unreasonable result, namely that the exchange of commodities such as sugar, cotton, iron and copper for a deferred payment of gold or silver (or more generally, the sale of weighable articles for deferred payment) would be deemed unlawful because gold and silver are also weighable commodities.[335] The Ḥanafīs solved this problem by dividing weighable articles into those with a highly precise measure and all the rest, which reflects the necessity of this type of transaction. This distinction between weighable qualities was considered to be of enough significance as to permit deferred sales transactions.

---

[334] Saleh, *"Unlawful Gain"* (1986), 26.

[335] Ibid.

The famous traditionist Abū Bakr al-Bayhaqī catalogued a detailed record of different categories, forms and nuances of *ribā* transactions in his 40-chapter-book, *al-Sunan al-Kubrā*, which dealt with loans and sales involving general commerce and agriculture.[336] Likewise, al-Mālik's *al-Muwaṭṭa'* describes in detail the contemporary forms of *ribā* in loans, sales and exchanges of commodities. Both works underline the notion that the loan of basic foodstuffs (*ribāwi* goods), other commodities or money for a certain period for an increase is *ribā*.[337] Thus the development of *ribā al-faḍl* expands upon the meaning of *ribā al-nasī'a* considerably. *Ribā al-nasī'a* is generally believed to have simply referred to an increase in principal in the debt of the borrower unable to pay at a stipulated time.

However, the content and essence of *ribā al-faḍl* has been a point of contention and controversy throughout Muslim history. As this examination demonstrates, this form of *ribā* is not clearly identified, nor is there a broad consensus on exactly what is meant by the term. It seems to be a hypothetical game of juristic hair-splitting that involves the exchange of goods, some fresh, others old, some refined by craftsmanship and some coarse, with little, if any, economic utility. Conservative modern scholars such as Haque claim that *ribā al-faḍl* and *ribā al-nasī'a* were both prevalent in pre-Islamic times and thus the idea that jurists and traditionists developed *ribā al-faḍl* in its systematic logic at a later date is wholly contested. However, chapter four illustrates the arguments of many well-respected modern scholars, and muftis alike who have challenged

---

[336] Haque, "*Ribā* " (1985), 68-69.

[337] Ibid., 13-14.

this notion of *ribā;* perhaps in an effort to enable the Muslim world to adapt to the exigencies of modern commercial life.

Furthermore, modern scholars have noted that conflicting Hadiths espoused by Hadith collectors undermine the definitional claims made by classical jurists. For example, Muslim, al-Bukhārī, al-Dārimī, al-Nasā'ī, Ibn Mājah and Ibn Ḥanbal each recorded Hadiths narrated through chains of transmitters whose general claim is "*ribā* is on loans" or as al-Bukhārī emphatically expressed: "There is no *ribā* except on loans".[338] However, many of these same authors, including al-Bukhārī, Muslim and other canonical collections also report the equivalency Hadith that was examined in section 3.7.2: "Abū Sa'īd al-Khudrī reported God's Messenger as saying, "Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like for like, payment being made 'hand to hand'. If anyone gives more or asks for more he has dealt in *ribā*. The receiver and the giver are equally guilty".[339] Apparently, this obvious contradiction in meaning did not go unnoticed and each of the schools had its own supporting Hadith.

In sum, the body of Hadith-material on this particular subject, which includes many other Hadiths dealing with the topics of excess and delay, indicates a marked trend toward a more rigid and conservative definition of *ribā*.[340] It is also evident that a clear and unanimous

---

[338] Rahman, "Ribā " (1964), 13.

[339] Ibid.

[340] Ibid., 17.

definition of the term did not exist, especially amongst the learned jurists. Furthermore, historical evidence of commercial transactions in the earliest Muslim centuries is completely missing in these discussions. A more in-depth appreciation of the way in which the term was understood by early Islamic traders and merchants impedes a more pragmatic discussion of how the prohibition was put into practice. While the Geniza documents point to a general understanding that all interest – no matter how small or exorbitant – constituted the forbidden '*ribā*, knowledge concerning the earliest Islamic centuries, in particular the famed '*ribā al-faḍl*, remains partial and unsatisfying. The following sections attempt to understand the way in which classical commerce was actually practiced.

3.8 HISTORICAL COMMERCIAL PRACTICES

The practice-oriented nature of Islamic commercial law is more easily understood as a result of an interesting analysis which determined that over 75 percent of the jurists from the third/ninth and fourth/tenth centuries either engaged in commerce or the handicrafts or originated from families whose members engaged in these professions.[341] In fact, the eminent scholar and eponym of the Ḥanafī school of law, Abū Ḥanīfah, was a dealer and exporter of Khazz silk from Kufa to his partner in Baghdad.[342] Therefore, an influential number of pious scholars who contributed to the formulation of God's law had an in-depth and personal knowledge of the commercial requirements of the marketplace and these demands evidently found their way into

---

[341] Cohen, "Background" (1970), 39-40.

[342] Ibid., 26.

the law. The following discussion concerns the partnership (*shirkah*), which was one of the primary tools of commercial exchange in the classical Near East.[343]

3.8.1 THE PARTNERSHIP (SHIRKAH)

The *shirkah* is an ancient form of business association that has been practiced in the Near East since the days of Babylon as evidenced by its mention in the Code of Hammurabi, the Talmud, its treatment in the *Corpus Iuris Civilis* of Justinian and in the Gaonic *responsa* of the ninth and tenth centuries.[344] Another credit institution, the *qirāḍ* partnership, seems to have been endemic to the pre-Islamic Arabian tribes in their pursuit of the trans-Arabian caravan trade.[345] With the Islamic conquests the *qirāḍ* was introduced to outlying provinces of the Near East, North Africa, and eventually to Southern Europe where it was known as the *commenda*.[346] It can unequivocally be stated that the *qirāḍ* is the earliest example of a commercial association that bears similarity to the later *commenda* in all its essential features.[347] The *qirāḍ* also became known as the *muqarāḍah, or muḍārabah*, depending on the region in which the contract was exercised and the preferences of the schools of law. The distinctive form of partnership known

---

[343] Udovitch, "*Partnership"* (1970), 8.

[344] Ibid., 8. Mallat, "From Islamic" (2003), 706.

[345] Udovitch, *"Partnership"* (1970), 172.

[346] Ibid.

[347] Udovitch, "Commenda" (1962), 207.

as *qirāḍ* and *muqarāḍah* apparently originated in the Arabian Peninsula while the *muḍārabah* is of Iraqi provenance.[348]

The *Geniza* records attest to the surprising fact that at least one-half of the international trade was based on a series of highly complex, informal business partnerships, which spanned the Near East from Morrocco to Mesopotamia, and could last a lifetime. This fact is in keeping with our understanding of custom, of the proximate and trusted partners and agents, and locally available information which typify the 'local knowledge' criteria of successfully conducting commerce in the classical Near East.[349] Thus the Mediterranean and Indian trade, the most important trade routes of the period, were largely based on informal relationships rooted in mutual trust and friendship, and lacking any formal legal instrumentation.[350] Moreover, an *'umlah* or commission was only rendered for a special service; no compensation was given for extraordinary expenditures of time and effort which these informal undertakings often required. Instead these partnerships flourished in reciprocity as the sources confirm that "he serves there and I serve here", and "you are in my place there, for you know well that I am your support here".[351]

Formal partnerships tended to be of shorter duration and limited to specific undertakings, although many long-term business relationships seemed to have combined the two.

---

[348] Udovitch, *"Partnership"* (1970), 172-74.

[349] Geertz, "*Local Knowledge"* (1983).

[350] Greif, "Reputation" (1989), 859.

[351] Goitein, "Partnerships" (1964), 316.

Partnerships encompassed practically every economic activity in the *Geniza* period due to the fact that they substituted for large fields of economic activity that would subsequently be housed in alternative contractual forms: namely, employment and loans on interest. Partnerships ran the gamut from industrial pursuits such as: the running of workshops, wine production, and the building of homes; and commercial projects in both wholesale and retail trade; or projects related to the administration of the state such as tax farming (the fiscal basis of the state), and occupations in the royal mint or exchange, and so forth.[352] Money, goods, work, or any combination of the three, could form the basis of a partnership and records detail a number of diverse constellations. There are two general vehicles of partnership which encapsulate this commercial activity, one of which has been discussed. The second, known as the *shirkah* (also *sharikah)*, or perhaps more commonly as the *khultah* (literally, the mixing of the investments) describes contractors who offer their services in various shares and share the profit or loss in proportion to their investment.[353]

The popularity and widespread usage of the *qirāḍ* reflect the unique character of the contract. An investor could harvest the advantages of a loan as the *qirāḍ* entailed no liability for the investor beyond the sum of money or quantity of merchandise extended to the agent. In the event of a successful venture, the agent was to return the capital plus a share of the profits. Meanwhile the agent could claim complete indemnity from any liability for the capital, in the

---

[352] Goitein, "*Mediterranean"* (1967), 170.

[353] Ibid.

event of a partial or total loss.[354] Furthermore, the investor reduced the cost of trade by using partners and/or agents to undertake business dealings on his behalf. Further, risk allocation could be better managed through trade diversification with respect to goods, location and time.[355]

In the contract of *qirāḍ* one of the most crucial issues was in determining the legitimate cost to the seller of any given commodity so as to be able to determine the profit in excess of total cost. According to Ḥanafī law the single most important guideline in making this determination was the customary practices of the locale in which the transaction was to take place.[356] It is a definitive example of how the sharia incorporated local business practices.

Moreover, the enforcement of the ban on investment in the form of goods or merchandise would have dealt a severe blow to medieval commerce, particularly for those engaged in long-distance trade. It was common that merchants had nearly all their capital invested in goods and merchandise, which could not always be sold advantageously at a certain locale. A number of quite simple legal devices, i.e. *ḥiyal,* were developed to circumvent this prohibition. The merchants were to have made frequent use of them so that these subsequently were incorporated into the legal manuals and the earliest legal formularies (*shurūṭ*).[357] The assimilation of the *ḥiyal* in the *fiqh*, including contractual formularies, was so complete and

---

[354] Udovitch, "Commenda" (1962), 200.

[355] Greif, "Reputation" (1989), 863.

[356] Udovitch, "Law Merchant" (1970), 120-21.

[357] Ibid.

without reservation that their extra-judicial quality was eventually forgotten and omitted from the texts.[358]

The *qirāḍ* was often the source of partnership between Muslims and Jews and could be formed by a variable number of partners and partnership stakes, while profit, loss and expenditure were divided in proportion to the investment. So, for example, a Tunisian merchant had a one-sixth stake in a 365 dinar-partnership in which lacquer was transported from Egypt, while he maintained a five-sixths stake in a shipment of indigo and sal ammoniac dispatched from the same country.[359] So adept and practical in the field of commercial exchange were the Arabs that their widespread use of complex credit facilities throughout the Islamic territories pre-dated a similar European development of credit by at least three or four centuries.[360]

The *qirāḍ* partnership was the subject of lengthy discussion in the earliest Islamic legal literature (late eighth century CE), and the refinement and tone with which it is treated indicates its historical antiquity. In addition to citing a number of Hadith relating to the Prophet and his companions, al-Sarakhsī justifies the permissibility of the *qirāḍ* contract on the grounds of commercial necessity: "in relation to this contract, the requirements of the law yielded in face of the people's need for it". Furthermore, when commercial practice was stymied by the broad restrictions relating to analogical reasoning, Ḥanafī jurists were inclined to exercise the

---

[358] Ibid.

[359] Goitein, "Partnerships" (1964), 321.

[360] Udovitch, *"Partnership"* (1970), 77.

prerogative of *istiḥsān* and thereby suspend the rigid application of strict analogy.[361] In addition to enhancing the flexibility and efficiency of market players, these principles succeeded in adopting large swathes of commercial customary practices into the Islamic fold.

Although the Quran does not mention the *qirāḍ*, traditions attribute it to the practice of the Prophet and his leading Companions. One tradition places Muhammad as an agent in a *qirāḍ* investment with his future wife, Khadīja, and ‘Umar and ‘Uthmān, the second and third, respectively, of the rightly guided caliphs, are known to have participated in these ventures.[362] The sharia admitted these partnership practices on the grounds of traditional practice, the consensus of the community *(ijmā’)*, and its practical application for the well-being of the Muslim community.

The imperatives of commercial practice were not limited to the *qirāḍ*. For example, a labour partnership between a stall-owner and an artisan illustrates a contract of widespread commercial importance throughout the classical period. In a partnership described by al-Sarakhsī, a stall-owner allows an artisan to utilise his stall, whereupon all profits were to be split equally amongst the parties; the same would apply to loss in the event of misfortune.[363] Such a partnership would be rendered void on account of the artisan’s intangible investment, at least in monetary terms; and the stall-owner’s provision of his stall is equally difficult to value and is thus

---

[361] Ibid., 251.

[362] Ibid., 175.

[363] Udovitch, "Law Merchant" (1970), 118.

prohibited as a means of investment in a partnership. Likewise, the terms of the contract do not satisfy the conditions inherent in the contracts of hire or lease (*ijārah*) as the terms of the agreement have not been specified prior to the conclusion of the contract.

Al-Sarakhsī offers his insight into why this sort of arrangement was permitted: "By exercising juristic preference (*istiḥsān*), he [i.e. Shaybānī] permitted this arrangement because of its continuous use in the affairs of men without any disapproving voice being raised against it. Objecting to transactions which are in common use among the people is in itself a type of offence. In order to avoid this offence, this contract is permissible. For there is no explicit text nullifying it, and the people have a need for this contract […]".[364] This is a more evident example of the differentiation between the adoption and subsequent Islamisation of customary usages of clear economic relevance, on the one hand, and the ideal theory of the sharia, on the other. But the adoption of customary practices is not merely a reasoned abandonment of the *uṣūl al-fiqh* in favour of a more practical and flexible approach to the law. On the contrary, it depicts a pliant and willing belief-system, which in bestowing its grace and permission upon a set of not incompatible acts, enhances the strength and vibrancy of the Muslim community, and by extension, the Muslim faith.

The Cairo Geniza papers are not always clear with respect to which law, Jewish or Islamic, governed a contract. There is considerable circumstantial evidence, however, which indicates

---

[364] Ibid., 117.

that local custom (the so-called merchant's law) and the contractual terms and conditions as agreed by the contracting parties established the guidelines regulating a contract.[365] Most of the Geniza documents available with respect to the governing law are court records. There are a number of records which deal with the termination of a partnership, known as a release. These releases were statements confirming that the parties to a business association had relinquished their claims against one another. Naturally, settlements were made out of court, or before Muslim notaries. It is likely on account of the common usage of the Muslim *qirāḍ* that these settlements were made in the presence of Muslim notaries.[366] The following section analyses the use of interest in classical transactions.

3.8.2 THE USE OF INTEREST IN COMMERCIAL TRANSACTIONS

It is evident that Islamic ideals reinforced already strongly entrenched beliefs concerning the immorality of the practice of levying and paying interest. For instance, evidence from the Cairo *Geniza* show that lending on interest was not only shunned religiously but was of little economic importance throughout the tenth and eleventh centuries. It is thought that people at the time felt as though the acceptance of interest, or, perhaps unusually, employment, was to denigrate one's person as "the borrower is a slave to the lender" (Proverbs 22:7); a dependent relationship lacking dignity.[367] This mentality is highlighted by the then current notion of giving

---

[365] Goitein, "*Mediterranean"* (1967), 171.

[366] Goitein, "Partnerships" (1964), 328.

[367] Goitein, "*Mediterranean"* (1967), 254.

loans (*qarḍ ḥasan*) as an act of charity, which accords with the requirements of the sharia that loans bear no interest, and, in fact, be given as an act of charity without recompense in this life. Such loans were commonly advanced amongst relatives connected by common commercial undertakings.[368]

In the twelfth century, the Geniza shows that the mood shifts so that fixed interest, *ribā* (*ribbith* in Hebrew), is evidenced in documents which openly flaunt the prohibition. In this period it becomes unlikely that large amounts of money, such as 300 or even 180 dinars, which were lent for a period of six years, would not have been compensated without fixed interest or "service". Overall, however, scanty documentary evidence highlighting the use of interest likely indicates that appearances were kept up, so to speak, and thus the use of interest openly was still perceived as a social and religious anathema. Indeed, it seems that the creditor's objective was to arrange for an increase for himself without publicly stipulating such profit in a signed and notarised contract.[369]

A telling sign of the times is evidenced in both Muslim and Jewish willingness to lend on interest to members of the opposing religion, whether it was for commercial or simply consumptive reasons. For instance, the terrible wars of the 1020s witnessed the decimation of the Jews of Jerusalem who were subsequently forced to borrow from Muslim usurers to pay the poll tax. In one Cairo *Geniza* letter signed by ten residents of the Holy City and posted to Old Cairo around

---

[368] Ibid.

[369] Lopez and Raymond, "*Trade*" (1955), 159-61. Labib, "Kredit" (1959), 238.

1040, it is written: “In the current year we took a loan of 40 dinars for the poll tax alone from the usurer known to you”.[370] While the taint of interest has had a genuine social impact over centuries of religious practice, at least to the extent that it was clearly a sin according to all of the monotheistic religions, its usage has nonetheless waxed and waned over centuries of commercial practice.

During the reign of the Ottoman Empire, for instance, lending at interest was a condoned practice. In fact, *ribā* or *fā'ida* (interest) at relatively low rates was perceived as different from the usurious form condemned in the Quran. An interest rate of 15 per cent was legally sanctioned. The clergy stood squarely behind the ruling and had those people, who denied its validity, persecuted according to the Ottoman understanding of the sharia.[371]

Classical commercial practices indicate that customary business practices were adopted within the Islamic fold when their benefits were obvious, despite the fact that some of these practices exceeded doctrinal limits. The flexibility and pragmatism with which the sharia treated such practices provides a strong indication of jurists' willingness to adapt and extend the law to commercial requirements.

---

[370] Goitein, “*Mediterranean”* (1967), 257.

[371] See Çaĝatay, "Ribā ” (1970), 65. Lending at interest, according to Çaĝatay, was a generally accepted practice from the 10th/16th century onwards. See also Zubaida, “*Law”* (2003), 110; And Jennings, "Loans” (1973).

CONCLUDING REMARKS

The system of Islamic nominate contracts is premised upon the divine covenant. While many of its rules were laid out in the holy sources, numerous areas of law were not touched upon. The jurists' task was to formulate a body of substantive law that accorded with the textual substance (*'illah*) of the revealed texts. This resulted in a disparate group of nominate contracts that each contained their own rules and particular legal effects. The intricate rules which characterise the system of nominate contracts entail many restrictions upon contracting parties' freedom to contract. However, jurists made some allowances for exceptions to general principles – such as the contracts of *istiṣnā'* and *salam* – that offset some of the doctrine's more rigid features.

The textual hermeneutic from which jurists sought to formalise the law helped to generate complex rules concerning *ribā* and *gharar.* The classical schools of law interpreted each prohibition differently for a variety of reasons. In general, it was assumed that God had prohibited *ribā* and *gharar* to abolish exploitation and to mitigate injustice in contractual deal-making. However, the manner in which these principles should be defined has been the subject of debate since their juristic inception. At any rate, it seems that the great majority of Muslims has understood *ribā* as interest from a very early date. *Gharar,* on the other hand, was not as easily formulated. Its effects in classical commerce were less restrictive due to the types of contracts available in that period. In some areas of the doctrine, however, the concept could have restrained trade and commerce markedly. However, jurists cautiously devised robust

exceptions to the prohibition that permitted much-needed commercial and trading activity.[372] Both prohibitions affect the structure and content of Islamic contracts by circumscribing what parties can contractually undertake.

While the law of Islamic nominate contracts is fairly rigid and generally restricts parties' freedom to contract, school doctrines ameliorate this rigidity considerably by accommodating customary business practices. Customary practices were either condoned because the community (*umma*) had a definite need for them or because they had used them for so long that it made no sense in forbidding them. Many of these practices were incorporated into *fiqhi* doctrine via the process of Hadith or *ijmā',* while rationalising legal principles were used to accommodate others.

The historical practice of Muslim commerce bears witness to the predominance of custom in commercial transactions. Classical business transactions, not unlike contemporary ones, were undertaken according to the needs of traders and merchants. The ability of the sharia to envelop all sorts of practices – some of which clearly transgressed a conservative interpretation of school doctrine – testifies to the law's historical ability to adapt to changing commercial imperatives.

In the next chapter some of the complex legal and economic challenges affecting the modern Muslim world are considered as well as Islamic legal responses to these challenges.

---

[372] Subsequent chapters show that the *gharar* prohibition has gained in importance due to modern financial innovation and other competitive practices.

PART II: THE CHALLENGES OF ARTICULATING THE LAW OF ISLAMIC FINANCE

CHAPTER FOUR: THE MODERN ECONOMY AND ISLAMIC FINANCIAL IJTIHĀD

INTRODUCTION

This chapter has two principal objectives. First, it investigates some of the complex economic and legal challenges affecting the modern Muslim world. Second, it examines the strategy, methods and tools used to respond to these challenges and which ultimately produce the LIF. It is asserted that jurists' legal articulation of these challenges reflects a formalistic approach to deriving the law that is designed to retain an allegiance to classical legal theory and tradition. However, the LIF is a hybrid law that diverges in both form and substance from the sharia.

These objectives are addressed by examining the following topics: first, the role of money in the modern world and its effects upon economic activity and social interaction; second, the displacement of the sharia throughout the Muslim world in the modern era; third, Muslim intellectual trends and their relevance to the contemporary interpretation of *ribā;* fourth, Islamic economics and interest-free banking – the offshoots of these intellectual trends; fifth, the prevalent trends of contemporary Islamic finance; sixth, the role of transnational financial institutions; seventh, the commercial drive toward standardised Islamic financial contracts; and finally, Islamic legal strategies and methods for formulating the Law of Islamic Finance.

4.1 THE NATURE OF MONEY IN THE MODERN WORLD

The development of Islamic finance is intimately connected to the social, economic and psychological role of money in the modern world. The use of money as a means of exchange as well as its representation of value has undergone enormous change since the classical centuries of Islamic commerce. These changes have altered the way in which people think about and transact in money. They also present major challenges to classical Islamic conceptions of dealing in money-based transactions. This section analyses the challenges associated with the modern world's use and perception of money.

Money means different things to different people. Economists view money as purchasing power or the representation of the value of all items of wealth. Although lawyers recognise this conception, they make many differentiations in law that economists do not. [373] Thus, bank accounts are debt, not money; and "deposit accounts are not even debts payable on demand", and so forth.[374] Furthermore, money is highly self-referential. It only comes into existence if people believe that something is money, use it as money and treat it as money. Therefore, the attitude that people have towards money "is partly constitutive of the phenomenon".[375]

---

[373] Mann, "*Money*" (2003), 28.

[374] Ibid., 5.

[375] Searle, "*Social Reality*" (1996), 32-33.

The modern development of complex monetary systems enables the signification of value in a multitude of forms, including the most familiar media of exchange such as bank notes, letters of credit and bills of exchange. However, the technological revolution, in particular the use of electronic money transfer systems, has dramatically transformed our ability to conduct transactions – by the addition and subtraction of intangible numerical symbols in accounting ledgers – in a matter of seconds, irrespective of location.

Even the most highly developed monetary systems of the pre-modern era, the Roman Empire, never advanced beyond the use of 'commodity money', which took the shape of material coinage and was made of precious metals including gold, silver, copper and iron.[376] In rudimentary monetary economies the value of the supply of precious metals may have been determined by their alternative use as an adornment; although as economies began to produce more goods this condition seems to have gradually disappeared. In medieval and early modern Europe, as a result of a growing psychological indifference to metal money in terms of its value as a metal, and the introduction of banknotes as mediums of exchange, money increasingly came to be equated with paper money.[377]

In traditional economies the desire for symmetry regulated the exchange of money. A large token of value was demanded for large objects; in the Islamic tradition this required the

---

[376] Smith, "*Wealth"* (1993), 22.

[377] Simmel, "*Money"* (1990), 143. For a more detailed explanation of fractional reserve banking and the monetary system see El-Diwany, "*Interest"* (2003), chapter 2.

exchange of like for like and the imposition of intricate rules for weighing and measuring. Recall that the Cairo Geniza records indicate that as late as the 13th century CE coinage was weighed and assayed; this reflected people's perception that value resided in the metals themselves. Only as economies began to disassociate money from precious metals did such cultures realise that a considerable quantitative inequality could still permit an equality of power and value. This step is symbolically important in that it represents an abstraction, in which one half of the equation no longer functions as a value in itself but is the abstract expression of the prevailing counter-value.[378] Eventually a consciousness of money as dematerialised or imaginary was fostered through the dislocation of money of account and precious metal coinage.[379] Although the ideal significance of money as a standard and expression of the value of goods has remained completely unchanged since the use of money first began, money's character as a means to store and transport values has evolved and is still in the process of changing.[380]

The introduction of banknotes as currency hastened the development of fractional reserve banking. The reserve of gold to bills of exchange in issue was termed the "reserve ratio". As the goldsmith bankers of seventeenth century England realised that people began to view paper receipts as money, these could be lent out at interest rather than gold. In those instances in which depositors' withdrawals outweighed reserves of coins, bankers relied on reserve

---

[378] Simmel, "*Money*" (1990), 143.

[379] Ingham, "*Money*" (2004), 110.

[380] Simmel, "*Money*" (1990), 143-48.

arrangements to make up the shortfall.[381] Eventually the state's declaration that these paper receipts were as valuable as money effectively made them so.[382]

Eventually, this development led to money's detachment from particular individuals in the creditor-debtor relationship. Paper money became transferable to third parties and could circulate as private money within commercial networks. This marked the very first time in which the extensive production of money took place outside the state's monopoly of currency issue. Eventually these markers of debt adopted depersonalised terms similar to today's bills of exchange; such as 'payable to 'x' or the 'bearer''. The bills could now be issued by banks and hence the possibility to finance enterprise on a large scale came into view. The essence of capitalism, "the elastic creation of money by means of readily transferable debt" was born.[383]

In sum, money's significance has evolved from a direct and substantial function to its ideal form; namely, it produces its effects merely as an idea embodied in a representative symbol.[384] The value of money does not derive from the costs of its production, or from supply and demand (neo-classical economic theory), or from labour value (Marxist theory). Rather money is the absolute expression of abstract value; the value of things detached from the things themselves.[385]

---

[381] Diwany, "*Islamic Banking"* (2010), 382.
[382] Searle, "*Social Reality"* (1996), 46.
[383] Ingham, "*Money"* (2004), 108.
[384] Ibid., 148.
[385] Ingham, "*Money"* (2004), 64.

In modern times the collapse of the Bretton Woods agreement in 1971 represents a further step in the evolution of the modern world's perception of the value of money. As the US dollar became the medium of world trade in the post-war years, the agreement backed the dollar by a fixed convertibility into gold. Moreover, the US dollar was further buttressed by American political and economic supremacy. In effect, the US economy became the guarantor of international value.[386] The shift to a global system of floating exchange rates ended dollar-gold convertibility but at the same time presaged a new phase in which the immaterial form of value gained meaning. In particular, exchange rates between different currencies have been extremely volatile and reflect, in part, the competitive economic position and overall power of nation-states' economies. But these are hardly absolute qualities and are thus in constant flux. The effect is to render spaces, in this case, national economies, that underpin the determination of value as unstable as the determination of the value itself.[387]

4.2 THE GLOBALISATION OF FINANCE

These developments, coupled with the deregulation of the domestic financial sector, the removal of barriers to capital flows and enormous advances in information technology, have led to a rapid globalisation of finance. In the era of the neoliberal capitalist economy finance has come to dominate the real economy. Known as the financialisation of the economy, the term

---

[386] Harvey, "*Postmodernity*" (1990), 296.

[387] Ibid., 297.

connotes the predominance of financial activities over the production of goods and services.[388] It also describes the increasingly speculative nature of economic activity and hence the de-linking of active production from the elastic creation of credit-money through the financial system. [389]

Approximately 95 per cent of daily financial transactions around the world had already become speculative in 1995. Twenty-four years earlier, in 1971, only ten per cent of all financial transactions were speculative.[390] In the United Kingdom, prior to the Great Recession of 2008-2009, finance contributed to twenty-five per cent of gross domestic product. At its peak, the US financial sector generated forty per cent of all corporate profits.[391] The speculative nature of the world capitalist system raises important questions for a mode of finance which seeks to create value through tangible assets; in effect, Islamic finance seeks to re-establish a linkage between value and manufactured goods and/or services that no longer exists in the modern era.

The financialisation of the economy is directly related to the system of fractional reserve banking. Commercial banks have the authority to create new money at almost no cost. Further, the greater the amount of money they create the larger the amount of interest revenue and profit

---

[388] Tabb, "Financialization" (2010), 149.

[389] Ibid., 151.

[390] Chomsky, "*Neoliberalism"* (1998), 23-24.

[391] Tabb, "Financialization" (2010), 151.

to which they are beneficiaries. Inevitably, commercial banks' power to create money increases the supply of money, the level of private and public debt, and contributes to inflation.[392]

Many major financial institutions maintain a reserve ratio of less than one-twentieth of total outstanding liabilities. For example, the 2006 Annual Report of HSBC showed that the bank held just £3.5 billion in cash to cover approximately £168 billion in on-demand liabilities, which equates to approximately 2.08 per cent.[393] Modern monetary reformers, including Islamic economists, argue that fractional reserve banking should be abandoned in favour of 100 per cent reserve banking; a concept that would extend credit through loans backed by 100 per cent reserves.[394]

4.2.1 CULTURAL PERCEPTIONS OF MONEY

The evolution of people's perception and use of money has undermined some of the central tenets of classical Islamic notions of commercial trade including the detailed and highly intricate rationale underpinning the prohibition of *ribā al-faḍl*. Recall that *ribā al-faḍl* calls for the exchange of equivalent counter-values in the case that these belong to the same genus or have the same underlying attribute (*'illah*), i.e. can be weighed, counted, etc., depending on the

---

[392] Diwany, "*Islamic Banking"* (2010), 383.

[393] Ibid.

[394] El-Diwany, "*Interest"* (2003), 69-73. The American economist, Irving Fisher, proposed the idea in *100% Money* (1936).

school of law. Counter-values that do not belong to the same genus and which do not evince the same underlying attribute may be exchanged upon delay and in excess. The modern world's use of money contravenes this aspect of the *ribā* prohibition in almost all cases, with the exception of trading money for money. Furthermore, financialisation raises important social questions about the mechanism by which value is measured and whether its disassociation from human labour and manufacture can be restored. It is uncertain whether Islamic finance can help to remake these associations.

Therefore, money is no longer viewed as a commodity but as a symbolically important representation of value. It may not be overstated that it is in the psychological realm that money's effects have had their most vivid consequences. Of course, it is oversimplified to conflate money with the ideology of capitalism and free market values. Clearly, the extent to which money "ushers in a world of moral confusion" varies greatly from culture to culture[395] and, necessarily, according to a person's proclivities and intrinsic nature. Although the development of money has evinced a radical transformation of society, it cannot necessarily be linked to a radical transformation in a society's worldview. Anthropological research indicates that the meanings with which money is associated are highly dependent on the cultural matrix in which it has been incorporated. Even the economic functions of money as a means of exchange, unit of account, store of value and so on are endowed with diverse symbolic meanings,[396] according to their social and political context.

---

[395] Parry and Bloch, "Money" (1989), 18.

[396] Ibid., 21.

Furthermore, it is likely that every culture of exchange possesses an intrinsic drive toward optimum commoditisation – to create and exchange as many items as the existing exchange technology, i.e. money, will allow.[397] The introduction of money can be seen as a response to this feature of human nature and in all societies in which it has been introduced – regardless of whether some adherents initially rejected its use or not – a rather uniform process of commoditisation has proceeded rapidly and extensively. The internal logic of exchange seems to have predisposed all economies to seize upon the new opportunities that expanded commoditisation brings with it.[398]

4.2.2 MONEY, CAPITALISM AND MUSLIM INTELLECTUALS

Capitalism's channelling of all things into commodities, capable of being owned as private property and valued only insofar as they can be inserted into the productive process, as measured by the margin of profit, presented modern Muslims with a fundamentally different conception of material affairs and social transactions than the classical Muslim commercial tradition. Importantly, these processes engender heightened consumption and, in turn, the satisfaction of individual wants and desires.[399] Muslim intellectuals including notably Jamāl al-Dīn al-Afghānī, Muhammad 'Abduh, Rashīd Riḍā and Rafīq al-'Aẓm voiced considerable

---

[397] Kopytoff, "Commoditization" (1986), 72.

[398] Ibid.

[399] Tripp, "*Moral Economy*" (2006), 3.

antipathy and misgivings about the capitalist system and its one-time socialist competitor. Al-Afghānī was preoccupied with the normative order conveyed by capitalism, rather than its material conditions and the concomitant processes of labour and industrial production. In a similar vein al-ʻAẓm was concerned with the secularising tendencies wrought by capitalist processes. He maintained that Islam, properly observed, was the only normative system which could ensure a moral economy based on solidarity, cooperation and the independence of the individual within just and equitable boundaries.[400]

In the modern capitalist world the division of labour and the commoditisation of all things have engendered a plurality of economic dependencies based upon the infinite flexibility and divisibility of money. Indeed, people of traditional economies were often dependent only upon themselves or a limited number of people, and thus the personal and committed nature of these economic exchanges was considerable. Modern economic systems reflect a dramatic extension and specialisation of our needs – even in the fulfilment of fundamental requirements such as food, clothing and shelter - and can be satisfied only with the help of wide and complex organisations of people,[401] many of whose functions are easily substitutable. Thus, the modern use of money has tended to foster impersonal and inconsequential relationships in commercial exchange, and is therefore destructive of community and the intimacy of commercial relations.[402] It has fostered a sense of independence and self-sufficiency for the elimination of

---

[400] Ibid.

[401] Simmel, *"Money"* (1990), 297-98.

[402] Parry and Bloch, "Money" (1989), 6.

the personal element in commercial exchange directs the individual toward his own resources and makes one more positively aware of one's liberty.[403] Furthermore, research in social psychology indicates that consumerism seeps into the life frameworks of individuals and eventually affects their self-perception and interests, their view of the world and their interaction with others.[404] The Muslim world has not been immune to these developments.

Successive modern Muslim intellectuals have perceived modernity's emphasis on individualism as a direct threat to Islam's communitarian ethics as these posit the basis, if not the prerequisite, from which all economic life in Islam must originate. The individualistic ethic is associated with capitalism, greed and materialism, and these values are thought to have stifled Muslim economic development.[405]

Finally, in its modern form money has come to be defined, above all, in terms of credit and debt and in this sense is closely related to time. As a mode of deferral, money enables contracting parties to delay the exchange of credit and liability in circumstances where immediate exchange of products is impossible. As a means of bracketing time, money extracts transactions out of particular milieux of exchange characterised by 'local knowledge'. Thus, money allows for the enactment of transactions between agents widely separated in time and space.[406] On the one hand, this has dramatically increased the web of transnational relations and flows of information,

---

[403] Simmel, *"Money"* (1990), 298-303.

[404] Storper, "Lived Effects" (2001), 105-06.

[405] Kuran, "*Mammon"* (2004), 31.

[406] Giddens, "*Modernity"* (1990), 24-25.

no matter their culture of origin; on the other, the far-flung nature of modern commerce has contributed to the depersonalisation of social affairs.

The wide-ranging change in the way in which money is perceived, used and treated has had a tremendous impact across the Muslim world. The very difficult challenges that this change ushered in coincided with the near total displacement of the sharia in the modern period, which is the object of investigation in the next section.

4.3 THE DISPLACEMENT OF THE SHARIA IN THE MODERN PERIOD

By the end of the 18th century European scientific, economic and military dominance had spread throughout the Muslim world.[407] By 1840 the Ottoman Empire had become economically subservient to a burgeoning European economy.[408] The Ottomans and their elites gradually came to believe that European legal codes should replace those areas of traditional Islamic law that were considered most inadequate to meet the demands of modernisation.[409] The Ottoman Empire responded by instituting a series of major reforms, known as the Tanzimat, which began in 1839 and lasted until 1876. These reforms included new commercial and penal codes: for example, the Ottomans promulgated a Commercial Code in 1850, a penal code in 1858, a Code

---

[407] Hourani, "*Thought* " (1984), 38.

[408] Foster, "Comparative Commercial Law" (2011), 14.

[409] Kourides, "Islamic Law" (1970), 384.

of Commercial Procedure in 1861, and a Code of Maritime Commerce in 1863. All of these were almost entirely based on French law.[410]

For its part, Egypt enacted French-based civil and commercial codes in 1875-1876 for the Mixed Court system and instituted a programme of reform that promulgated penal, commercial and maritime codes derived from the French legal system.[411] These types of legal transfers eventually became thoroughly indigenised to the extent that Muslim majority states have not shown any willingness to revert to a legal system based purely on the classical sharia with the exception of Afghanistan under Taliban rule.[412] Indeed, one scholar asserts that by the mid-twentieth century the sharia "had been reduced to a fragment of itself at best and, at worst, structurally speaking, to a nonentity".[413]

Despite the dominance of Western-based legal systems throughout the Middle East, the sharia does play a limited role in these states' legal systems. Saudi Arabia is the country most influenced by the sharia in that its Basic Law is rooted in the Quran and Sunna.[414] This is also due to the fact that it was the country least affected by European colonialism, it hosts the two holiest cities of Islam, Mecca and Medina, and largely subscribes to an ultra-conservative strain

---

[410] Ibid., 385. And Anderson, "*Islamic Law* " (1959), 21-24.

[411] Kourides, "Islamic Law" (1970) , 385.

[412] Foster, "Comparative Commercial Law" (2011), 14-15, 32.

[413] Hallaq, *"Sharia"* (2009), 284-85. See also Anderson, "*Law Reform"* (1976), 1-2.

[414] See Saudia Arabia, "Basic Law" (1992).

of Sunni Islam know as Wahhabism.[415] However, it too has enacted a parallel body of secular law, which it conveniently refers to as "regulations" so as not to offend its conservative religious elements; and has separate, specialist dispute resolution bodies in the commercial field. These regulations, if found to conflict with the sharia, would almost certainly be overturned in a sharia court, thus confirming the sharia's pride of place.[416] Other Muslim-majority states such as, Kuwait, Bahrain and the United Arab Emirates (UAE) cite the sharia as "a" source of their constitutions whereas Qatar and Egypt designate the sharia as "the" source.[417] As a result, there is considerable uncertainty surrounding what role the sharia will play in solving a legal problem. Whereas the sharia may not impact upon a commercial dispute tried in Kuwait (for reasons associated with the principles of its Civil Code) and the sharia "basically" plays a role in Saudi Arabia, other jurisdictions range in the degree of uncertainty somewhere between these two extremes.[418]

In the next section the intellectual trends that accompanied the displacement of the sharia are examined. In particular, the contemporary debate concerning the interpretation of *ribā* is considered, since it represents a salient feature of how the modern Muslim world has appropriated Western financial practices.

---

[415] Sloane, "Status" (1988), 751.

[416] Ballantyne, "*Commercial Law"* (1986), 46.

[417] Ibid., 49. According to Egypt's provisional constitution. See Egypt, "Constitutional Declaration" (2011), art 2.

[418] Ibid.

4.4 MODERN ISLAMIC THOUGHT AND CONTEMPORARY RIBĀ

European economic dominance led to the introduction of mostly French-inspired constitutional reforms, premised upon Western-derived forms of banking. The use of interest in commercial banking became widespread and was unabashedly implemented across the wide spectrum of Muslim-majority countries. In nearly every country of the Muslim world today the practice of lending at interest is not only accepted but enshrined in states' commercial codes. It was at the turn of the twentieth century, under the yoke of European colonial power,[419] when these realities seem to have triggered an old yet pent-up debate on the meaning and permissibility of *ribā*.

Military, economic and political domination at the hands of European powers contributed to a widespread sense of Muslim enfeeblement and humiliation by those who felt that they were heirs to one of the world's greatest civilisations.[420] Simultaneously, Muslim society grappled with an acute sense of bewilderment as images and products from the West demonstrated Western technological and scientific superiority. A greater willingness to receive secular Western social, cultural and moral values into traditional life was seen by many as the means by which Muslim civilisation could restore itself to its rightful place amongst peoples. This multitude of converging influences gradually transformed the cultural and social values of the Muslim world.

---

[419] Wood, *"Islamic Proofs"* (2006), 18.

[420] Ibid.

An influential strain of thought responded to these challenges by returning to those sources of Muslim religious and social life that were perceived as the essence of the Muslim civilisation's strength and vitality. This line of thinking envisioned society organised on the basis of the Quran and the Sunna of the Prophet; the secular excesses of the Muslim world should be rejected.[421] Inherent in these calls for reform was the assumption that Muslim civilisation lagged behind its rivals because it had strayed from the path of Islam. Jamāl al-Dīn al-Afghānī (1839-97), an influential forerunner of the modern reformist movement, recognised that Europe's successes were attributable to its scientific revolution, but believed that Muslim civilisation lagged far behind because it had become ignorant and weak due to a fundamental erosion of Muslim morality. This had to be rectified before Europe's rational sciences could be usefully adopted into Muslim lands.[422] According to al-Afghānī, Islam and reason are not incompatible, but Islam must provide the moral principles that channel human reason.[423] Al-Afghānī's even more influential disciple, the Egyptian jurist Muhammad 'Abduh (1849-1905), also believed that the symptom, the Muslim world's weakness, was an outward manifestation of the underlying cause.[424] The overriding sentiment amongst these thinkers was that only the unadulterated values, principles and morals of the sharia could restore Islamic civilisation to its rightful place amongst peoples. The sharia is not only relevant but necessary for all times and places.

---

[421] Saeed, "*Interest*" (1996), 2.

[422] Hourani, "*Thought*" (1984), 114.

[423] Ibid., 123.

[424] Khoury, *"Modernisation"* (1976), 52.

Two of the most important and revolutionary native movements to emerge from this volatile environment were the Muslim Brotherhood (*al-Ikhwān al-Muslimūn*), founded by the Egyptian activist and reformer Ḥasan al-Bannā' in 1928, and *Jamā'at-i Islāmī* (Islamic Party), founded by the Pakistani scholar Abu 'alā Mawdudī in 1941. Mawdudī, who coined the term "Islamic economics" around the time of India's partition, called for the Islamic transformation of the existing political, legal, social and economic institutions of Muslim societies in accordance with the principles and rules laid down in the sharia.[425] In particular, the Muslim Brotherhood voiced its disapproval of the interest-based financial system in Egypt and elsewhere in the Muslim world. According to the Brotherhood, all interest-based activities should be prohibited and efforts made to develop an interest-free banking system.[426]

Mawdudī longed for an Islam opposed to the *jāhilīyah* in all its shapes and forms. Social life should be freed from *bid'a* (innovation), which in their core are clearly Western-influenced and run counter to the spirit of Islam. Mawdudī saw a widening gap between the ideal theory of Islam as espoused in classical Islamic doctrine and the application of Islam in daily life. He identifies this gap with hypocrisy (*nifaq*), which has effected a separation between God on one hand, and man's practical life (*mu'āmalāt*), on the other.[427] The depth of this feeling is not merely an exercise in political activism. Rather it is a call for fundamental change in the

---

[425] Saeed, "Ribā " (2008).

[426] Saeed, "*Interest"* (1996), 2: 9.

[427] Ahmad and Ansari, "Mawdudi" (1979), 374-77.

present-day Muslim world, which requires critical self-appraisal and painful adjustments to rid Muslim life of Western domination.[428]

Despite these calls to purge Muslim society of its Western-influenced ills, Muslim societies have changed irrevocably over the course of time as a result of their ever-increasing encounters with Western states, and their societies' own evolution in the world at-large. Societies no longer barter for their goods and money exchange operations take place with deferment. Furthermore, the availability of a wide array of goods and services from the far reaches of the earth overwhelm the systemic logic that governed the exchange of equivalent counter-values. *Ribā* could no longer be associated with the extensive and highly systematised *ribā* of the classical legal literature, if it ever was. Eventually, it acquired its sleeker, simpler definition as recognised by an overwhelming majority of scholars and pious Muslims in the modern world: namely, interest.

Ribā has thus reverted to the early Hadith whose general thrust equated *ribā* with "a loan with interest". The neo-revivalists have been quick to address this meaning with respect to the ancient practice of doubling and re-doubling the principal of a debt past due. They explain the Quranic verse as an example that strikes at the root and principle of usury, not as an indication of what is usurious *ribā* versus what is non-usurious *ribā*. Thus one of the early advocates of interest-free banking, Sayyid Quṭb, radically derides "anyone who gives me one dollar in order

---

[428] Siddiqi, "*Interest*" (1973), v.

to demand a return of two dollars from me is my enemy; I cannot have any friendly feeling for him, nor can I bear him any affection".[429]

Moḥammad Uzair, a conservative author, expresses a viewpoint that is characteristic of the neo-revivalists' unwillingness to enter into the debate on *ribā*, at least in terms of the arguments that modern revisionists advocate. Uzair claims that "there is a complete consensus of all five schools of *fiqh* [*…*] in the juristic literature, and among Islamic economists, that interest in all forms, of all kinds, and for all purposes is prohibited in Islam".[430] He dismisses modernists as Muslim 'apologists', a reference to modern Muslims' efforts to justify the principles and beliefs of Islam to the West. Further, the modernist notion that *ribā* could be differentiated along the lines of productive or consumptive purposes is simply bankrupt.[431] Uzair is hardly alone with respect to his uncompromising position. Other well-known authors approach the argument on nearly identical terms.[432] In allowing that the debate has reached a 'near-consensus' amongst Muslim scholars and practitioners, they attempt to dismiss their opponents' arguments without having to engage them in the minutiae of Islamic revelation. Indeed, their strongest claim rests on the divine injunctions of the Quran against the institution of *ribā*, or interest as they see it. Such divine commands are implemented on the basis of faith, morality and spirituality inasmuch as the Quran does not offer an explanation of the reasons or rationale for its prohibitions or condemnations. Nor should humanity expect God do so. The divine sanction for compliance

---

[429] Qutb, "*Justice"* (1970), 120-22.

[430] Uzair, "Interest Free Banking" (1984), 40.

[431] Ibid., 41.

[432] Ahmed, "Interest" (1984), 19; Ahmad, "Foreword" (1983), 7.

with these demands is cruel punishment in the afterlife.[433] In sum, the faithful must simply obey divinely-ordained commands and refrain from questioning the rationale behind such exhortations.

Many respected Muslim scholars have challenged the authority and simplicity of this formulation and have thus sought to differentiate the meaning of *ribā* as interest as opposed to usury. These scholars include but are not limited to: the Egyptian mufti Muhammad ‘Abduh and his disciple Rashīd Riḍā, the great Egyptian jurist, al-Sanhūrī, the Syrian politician Doualibi, and the modern Pakistani scholar, Fazlur Rahman, as well as official expounders of Islamic law such as the Grand Mufti of Egypt, Sheikh al-Azhar Muhammad Sayyid Ṭanṭāwī.[434] A brief illustration of some of their arguments is reminiscent of earlier debates concerning the proper interpretation of the Quran and the substantiation of these interpretations using Hadith.

Ibrahīm Zakī al-Badawī, whom al-Sanhūrī entrusted with developing an interpretation of *ribā* for implementation in the new Egyptian civil code in the mid-1930s, subsumed his argument in a report under what he described as the “limiting theory”. This theory derived from the interpretation of one of the most prominent companions of the prophet, Ibn ‘Abbās, who described *ribā* as that of the *ribā al-nasī’a*, e.g. the *ribā al-jāhilīyah* of pre-Islamic times. Al-Badawī’s liberal interpretation paved the way for article 227 of the Egyptian civil code, which allows interest, subject to a ceiling of 7 percent non-compound interest on loans. Surprisingly,

---

[433] Uzair, "Interest Free Banking” (1984), 41.

[434] For an example of this discourse see Mallat, "Debate” (1988). El-Gamal, "Interest” (2003-2004), 125.

twenty-five years later al-Badawī published a book that renounced his earlier interpretation. In it he wrote that it was wrong to distinguish *ribā* as merely the multiplied *ribā* that Ibn ‘Abbās had espoused. In his new work he elucidated what he called an “expanded theory” in which he repents of an unduly narrow view and attacks Al-Sanhūrī’s premise that *ribā* as a means is prohibited rather than *ribā* as an end.[435] Al-Badawī’s division of the concept into two categories, limited and expanded, offers an insightful perspective into the nature of the argumentation that has been waged since the concept came to light.

For his part, Al-Sanhūrī reinforced his more limited view of the prohibition by maintaining that the classical legal meaning of *ribā* should be understood as a prohibition of the means (*ṣadd al-dharā’i*). As a means it is not forbidden per se, rather it is designed to impede the development of a more fundamental *ribā*, that of the *jāhilīyah*. Accordingly, there are various degrees of the *ribā* prohibition and some are less absolute than others. Only in the case of dire need are the absolutely prohibited forms of *ribā* permitted. However, in all other cases of *ribā* – those which constitute the first steps of *ribā*, so to speak – these are allowed in the case of need as they do not meet the same prohibitive standards.[436]

Other modernists such as Doualibi and Rahman share arguments grounded in a sense of Islamic justice and fairness in commercial transactions. The *ribā* of the Quran, they claim, consisted of a usurious, unjust *ribā* which exploited the poor and weak, while the rich amassed

---

[435] Mallat, "Debate” (1988), 39-40.

[436] Ibid., 41.

their wealth amongst themselves. It is quite evident that these writers acknowledge the necessity of an interest-based global economy and the futility of swimming against the tide. Hence, their arguments attempt to differentiate between loans for productive purposes and loans for consumption; they claim that loans at the time of Quranic revelation were mainly for mere survival but that modern lending practices are geared for capital formation.[437] However, the modernist reformists have had little success in convincing the majority of Muslims that dealing in interest is permissible.

The modern debate concerning the meaning of *ribā* has been waged from a number of different vantage points, each of which espouses a modern vision for the Muslim world. In recent decades Muslims' perception of the prohibition of *ribā* has been strongly influenced by the rapid development of Islamic banking institutions on the basis of interest-free finance. In the following section the development of Islamic economics and interest-free banking is considered.

4.5 ISLAMIC ECONOMICS AND INTEREST-FREE BANKING

The progenitor of Islamic financial intermediation was the 20th century cultural and political movement known as Islamic economics. The early theorisers of Islamic economics include Sayyid Abu 'alā Mawdudī and Muhammad Baqr al-Ṣadr, a highly influential Iraqi Shi'a cleric. Both saw the influx of Western secular and material influences that threatened the role of Islam

---

[437] Saeed, "*Interest*" (1996), 2: 44.

in the Muslim world.[438] Both sought to distinguish a *Homo Islamicus* from neo-classical and Marxist theories of economics in largely qualitative terms.[439] In fact, few contributions to the literature have focused specifically on solving economic problems,[440] let alone those dealing with quantitative economic problems.

Islamic economics was to represent a decisive move away from the cultural foundations of the West and a concerted effort to rediscover Islam as a modern basis for all aspects of Muslim life.[441] Some of the principal characteristics of the Islamic economic model include the prohibition of interest (*ribā*), the provision of *zakāh* (religious levy) and the role of revelation and the hereafter.[442] It generally seeks to distinguish between two worldviews: the secular and materialist on the one hand and the spiritual and humanitarian on the other.[443] The secular and materialist worldview attaches importance to human well-being while ignoring the spiritual realm. It foresees material well-being in an individual's unhindered pursuit of self interest in accordance with an individual's wants and preferences. The spiritual worldview, on the other hand, also seeks to ensure human well-being, but it sees an integral role for spirituality and the knowledge of the hereafter as a reminder of God's final judgment. It also sees material and human benefits in the free pursuit of self-interest but it stresses the role of Islam to curb

---

[438] Ahmad and Ansari, "Mawdudi" (1979), 368-371.

[439] See, for example, Ṣadr, "*Iqtisaduna"* (1982).

[440] Kuran, "Discontents" (1996), 439.

[441] Siddiqi, "*Thinking"* (1981), v.

[442] Kuran, "Subeconomy" (1995), 156, 69.

[443] Chapra, "Islamic Economics" (2005).

unbridled self-interest. Hence, the wants and preferences of the individual should be tempered in accordance with Islamic principles and values. While both views recognise the role of the market in allocating and distributing resources, Islamic economics foresees a spiritual role that the market alone cannot fulfil.[444]

Therefore, Islamic economics does not differ with respect to the market's role in allocating limited resources, nor does it support price controls that would distort market signals.[445] Instead, it argues that Islam provides a moral filter that will help prevent conspicuous consumption or any wasteful and unnecessary consumption. There is little mention of what is meant by "conspicuous" or "wasteful" consumption. Furthermore, the Islamic moral filter should foster market equilibrium –"optimum economy" – in which material and spiritual needs are fully satisfied. Hence, the Islamic moral filter minimises the inequities or injustices that the capitalist system fosters via individuals' self-interested pursuit of material wants.[446]

Islamic economics stresses the role of good governance in helping to achieve these ends,[447] but it is also vague with respect to what is meant by "good governance" and does not offer specifics in terms of the state's role in this process.[448]

---

[444] Ibid. For a moralistic presentation of these differences see Khan, "Development" (2010).

[445] It does, of course, support the prohibition of interest, which is a key market signal. Islamic economics is vague about how the role of interest rates – as indicators of risk, inflation and economic competitiveness - can be effectively replaced by an Islamic system that deals only in tangible assets/manufactures and/or services.

[446] Chapra, "Islamic Economics" (2005).

[447] Siddiqi, "*Thinking"* (1981).

The means of fulfilling this vision reside in the creation of Islamic financial institutions (IFIs) and the interest-free banking model.[449] A wholly modern innovation, the IFI was originally conceived as a vehicle through which the 'Islamic personality' could be inculcated. Through numerous acts of individual private virtue the sum of Muslims' transactions would create the basis of an Islamic economy.[450] Its theorisers' highly idealised ambitions sought to distinguish it from the individualist characteristics and questionable moral practices of the capitalist economy. Not only would it remind people of their relationship with God, it would act as a guarantor of "faith, morals, peace of mind, the family and the society [...] to protect social and economic equilibrium".[451]

The Western legal concept of the joint-stock company was adopted to house the IFI. The joint-stock company has no antecedent in Islamic history, although some scholars have indicated that the classical *sharikah*, in particular its modern variant, the *mushārakah* partnership, provides a similar Islamic legal basis.[452] Balala argues that legal personality may be present in various Islamic contracts including the *waqf* (charitable trusts), *amanah* (trusteeship) and *sharikat al mulk* (shared ownership/partnership). This is a modern argument that asserts that

---

[448] Some authors argue that an interest-free banking system depends on the government prohibiting interest as a punishable offence. See Siddiqi, "*Interest"* (1973), xii-xiii.

[449] See, in general, El-Gamal, "Introduction" (2000).

[450] Tripp, "*Moral Economy"* (2006),138.

[451] Ibid.

[452] Siddiqi, "*Interest"* (1973),1.

Islamic law can harness some of its embryonic concepts for use in the modern world.[453] Usmani makes a similar case but delimits its application to public companies whose shareholders are so numerous that they should not be held responsible for day-to-day affairs and debts that exceed the value of their proportional ownership. Usmani accepts that the *muḍārabah* can be used to fulfil the role.[454] The *muḍārabah* investment partnership is considered similar to a modern corporation in that it separates ownership from control, is not limited to a certain number of partners, and its shares are transferable without dissolving the partnership.[455] However, the principal issue is not whether modern Western corporate law is compatible with the sharia but whether the sharia knew the concept of legal personality.[456] While there is disagreement about this, most modern scholars have accepted the concept with certain conditions.[457]

At any rate, early Islamic financial theorisers set out to replicate the modern financial intermediary and did this by creating a two-tier *muḍārabah* model of financial intermediation as a means of accepting deposits on the liabilities side of a bank's balance sheet. The *muḍārabah* is a profit-sharing contract in which the investor (*rabb al-māl*) entrusts funds to an agent or entrepreneur (*muḍārib*) to undertake an investment project in an agreed manner. The investor has no right to intervene in management decisions in the *muḍārabah* contract as opposed to the *mushārakah* profit-sharing contract in which both parties invest in the project and may

---

[453] See Balala, "*Theory and Practice"* (2011), 157.

[454] See Usmani, "*Introduction"* (2002), 108-09.

[455] Rahman, "Issues" (1998), 61.

[456] Foster, "Perspectives" (2010), 283.

[457] Nyazee, "*Partnerships"* (1997), 316-17. See also Ray, "*Renewal"* (1995), 38.

participate in management decisions. Further, any profits arising from the *muḍārabah* are distributed according to a pre-agreed profit ratio and then only after the investor has received his principal sum. Parties may not stipulate a ratio or percentage of the capital as profit as this would guarantee a return and thus constitute an unjustified enrichment (*ribā*). Any and all monetary losses are borne by the investor although these may not extend beyond the invested capital.[458] The agent is liable for his time and energy.

In the two-tier *muḍārabah* the IFI[459] acts as the agent (*muḍārib*) in accepting funds from an investor/depositor (*rabb al-māl*). On the assets side of its balance sheet, the bank (as an investor (*rabb al-māl*) this time) may choose to redeploy the funds with an entrepreneur (*muḍārib*). However, it may also choose from a number of debt-based contracts such as *murābaḥah, istiṣnā', salam* and so forth. The *muḍārabah* and the *mushārakah* represent the "twin pillars" of Islamic banking.[460] The *muḍārabah* will be examined in greater detail in chapter eight, section 8.1.

In this way, the sharia provides the legal means to help fulfil both the material and spiritual needs of a Muslim. Its integral role in Islamic financial intermediation is merely a confirmation of

---

[458] Lewis and Algaoud, *Islamic Banking* (2001), 41.

[459] The concept of an "Islamic bank" has been questioned due to the theoretical model upon which interest-free banks are supposed to function. This model is premised upon investment rather than debt creation, which is not usually associated with conventional retail banks. In practice, however, IFIs accept deposits and extend credit in much the same way as do conventional banks. This is investigated in depth in chapter eight, s 8.1.

[460] Lewis and Algaoud, *Islamic Banking* (2001), 45.

its undivided importance in a Muslim's life. It is a testament to the enormous prestige and authority that the sharia continues to command in the modern world.[461] In the following section some general trends in the modern Islamic finance industry are considered.

4.6 THE RISE OF GLOBALISED ISLAMIC FINANCIAL PRODUCTS

The global expansion of Islamic finance has included some of the largest and most-respected blue-chip corporations. General Electric became the first western industrial company to issue *sukuk,* valued at $500 million, as it sought to attract a new pool of investors.[462] The industry has also spread to some of the fastest growing economies. For example, China, which has a Muslim population of 80 million people, has begun to facilitate Islamic finance. Furthermore, South Korea and Thailand have expressed an interest in launching a sovereign *sukuk* issue.[463] Amongst Western countries, and those that have only recently begun to facilitate Islamic financial transactions, the UK's early steps to establish a legal and regulatory framework for Islamic finance has given the City of London an unrivalled competitive position.

The global expansion of the Islamic financial industry is reflective of a globalising trend in which transnational corporations spearhead financial innovation. Indeed, the development of sharia-compatible investments has involved multiple jurisdictions and market participants from a wide

---

[461] Vogel and Hayes, *"Islamic Law"* (1998), 3.

[462] van Duyn, "Bonds" (2009), 4.

[463] Y-Sing, "China Leap" (2009); Brown, "Inefficiency" (2009), 5.

range of countries and religious, cultural and legal systems.[464] A number of conventional multinational investment banks, including BNP Paribas, Calyon, Citibank, HSBC, JP Morgan Chase, RBS and Standard Chartered, together with recent newcomers such as Barclays and Deutsche Bank, have come to dominate the Islamic finance industry. In fact, according to a survey conducted by the Banker, the balance sheets of conventional banks offering "Islamic windows" rose from $622 billion in 2007 to $800 billion in 2008[465] - a clear indication of their competitive superiority relative to the industry's estimated size of $1 trillion. These conventional banks have chosen to adopt "Islamic windows" – conventional institutions that offer Islamic financial products and services - rather than developing dedicated Islamic subsidiaries, principally because "windows" leverage rather than dilute the financial strength of their respective institutions. Multinational financial wealth has enabled these institutions to offer far more resources to the industry than the fragmented Islamic finance sector, and as a result, much of the innovation stems from these banks.[466]

Multinational banks, once wholly unfamiliar with the sharia, not to mention Islamic finance, are now developing their own Islamic finance programmes and playing to their native financial strengths, including innovations such as derivatives. In many cases no suitable Islamic product exists on the market, yet market forces compel these institutions to seek the development of

---

[464] DeLorenzo and McMillen, "Law" (2007), 160.

[465] IFSL, "Islamic Finance" (2010), 1.

[466] Eedle, "Evolution" (2009/2010).

products that compete in both conventional and Islamic markets. The resulting pressure has led to a range of much more sophisticated financial instruments and products.[467]

Furthermore, the economic power of transnational corporations (TNCs) – a corporation that produces and/or delivers services in more than one country – may be so great that the legal environment itself is organised according to TNC operations. The market power of TNCs directly influences the commercial customs of the relevant market, if not by enshrining recognised commercial customs into standard form contracts, then by persuading courts and legislatures to include them in court opinions and/or codify them into statutory law.[468] Indeed, the full extent of transnational corporate power is evidenced in those markets in which the market leader's standardised use of particular contracts becomes the industry norm.[469] The origins of the most influential transnational actors determine the particular characteristics and nature of the law so as to reflect its native legal background and traditions. In particular, Fazio argues that the United States' dominance in the world economy as well as the proliferation of American TNCs throughout the world engenders an Americanisation of international commercial law.[470] The local ramifications of TNC activity resonate globally. Thus the growth of cross-border production networks and interlinked trade alliances encourages the development of

---

[467] DeLorenzo and McMillen, "Law" (2007), 160.

[468] Muchlinski, "Bukowina" (1997), 86.

[469] Ibid.

[470] Fazio, "*Harmonization*" (2007), 9.

global economic and regulatory uniformity,[471] requiring the Islamic financial industry to adapt to TNC-designed rules and strategies.

Some observers argue that IFIs have prospered in designing products which cater to the particular demands of local populations and their localised understandings of the sharia, whereas global financial services companies' product-design objectives increasingly strive for homogeneity. The conventional banking philosophy is based on the belief that everyone in the world has similar banking requirements and these revolve around three core products: savings, payments and investments. In focusing on these foundational contracts, conventional institutions have striven to achieve economies of scale. Service delivery to the largest possible number of people is made more efficient with the creation of a wide range of delivery channels and branches across the globe.[472] The large majority of new market entrants, including Islamic financial institutions, consists of small and medium-sized that are not able to adopt this strategy. Instead, IFIs have focused on identifying market niches that exploit the different needs of a multitude of diverse ethnic groups. This strategy is seen as a competitive advantage for small and medium-sized IFIs in developing brand recognition and an ability to foster better customer service.[473] The challenge for these institutions is to achieve a balance in which authentic product offerings are made viable while complying with growing calls for the standardisation of the market, a topic examined in the next section.

---

[471] Muchlinski, "*Multinational*" (2007), 89.

[472] DiVanna and Sreih, "*Islamic Finance*" (2009), 106.

[473] Ibid.

4.6.1 COMMERCIAL PRESSURES FOR STANDARDISED ISLAMIC FINANCIAL CONTRACTS

Transnational domination of the Islamic financial industry generates pressure to standardise Islamic financial contracts. Legal standardisation raises critically important religious and ethical questions concerning the central function of contingency in the sharia – the mere probability that the Muslim jurist has interpreted the sources correctly. Contingency in the law legitimises the normative pluralism within and between schools of *fiqh*; and has led to the peaceful co-existence of the various doctrines and normative systems.[474] It is the attribute that distinguishes a religious law from a state-based legal system with central legal authority. The issue of standardisation is closely related to the controversial debate concerning the codification of the sharia in the nation state.[475]

Standardised contracts have a long history in Islamic commerce. Developed over the course of centuries, *shurūṭ* (formularies) were designed to facilitate commercial exchange. Individuals engaging in a transaction could simply agree to engage in an *ijārah*, *salam* or *istiṣnā'* and have a notary produce the relevant standardised contract. However, classical *shurūṭ* were drafted according to the doctrine of the respective school of jurisprudence and could thus be arbitrated according to one's specific beliefs[476] and customary practices. Modern attempts at Islamic legal

---

[474] Johansen, "*Contingency"* (1999), 7: 38-39.

[475] For an overview of this debate see Vikor, "Shari'a" (2000).

[476] Wakin, "*Documents"* (1972), 10-11: 13 ; El-Gamal, "Introduction" (2000), 149.

standardisation highlight the inherent tension between the religious and ethical essence of the sharia and its functionality in modern financial markets.

The combination of vast multinational financial resources and the careful selection of widely respected sharia scholars may combine to buttress a dominant interpretation of *fiqh* (Islamic law) that reflects the interests of financial institutions.[477] Sharia supervisory boards are composed of at least three sharia scholars whose Islamic stamp of approval legitimises Islamic products and services.[478] AAOIFI recommends that all Islamic financial institutions form a sharia supervisory organ for a period of at least three years. Sharia boards should be appointed by the general assembly of bank shareholders and meet periodically or on-demand to examine special issues.[479] Major institutions employ at least one full-time sharia scholar so as to have their services available on an on-going basis.

As the Islamic financial industry has grown in prominence sharia scholars' fatwas have gained increasing recognition across the Islamic world as a result of the reputation of the scholar or the institution issuing them. The profile of sharia scholars has taken on renewed social and religious significance after a long period in which Arab nationalism and Islamic political movements largely sidelined the ulema. It has "brought the ulema back into the mainstream of

---

[477] Housby, "Development" (2005), 22.

[478] AAOIFI, "Standards" (2001), 5.

[479] Hardy, "Compliance" (2006), 209.

Muslim society".[480] Furthermore, sharia scholars' alliances with Islamic financial practitioners have reinvigorated the research and theorising of financial *fiqh* with an intensity and drive that nearly every other area of the sharia has not been given.[481] These alliances have arguably paved the way for the renewal of Islamic law more generally.

Some sharia scholars have gained recognition due to the liberal interpretation which they espouse. Many such fatwas have become general standards amongst Islamic financial institutions (IFI), amongst them fatwas which permit transactions once seen as unacceptable forms of trade.[482] The vested interests of financial institutions and sharia scholars may encourage legal interpretations that are geared toward strengthening the competitiveness of Islamic financial transactions. Ethical and religious considerations may not figure prominently in such considerations.

In 2009 the top three sharia scholars occupied 26 per cent of the total number of sharia board positions in the GCC, according to a research report issued by Funds@Work.[483] This concentration of expertise poses questions as to whether sharia boards are able to perform their auditing roles credibly. Clearly, IFI's own financial interests lead them to promote certain interpretations of *fiqh* and these may gradually become accepted by the Muslim populace at large. Islamic financial institutions' employment of sharia scholars is also controversial for the

---

[480] Kahf, "Islamic Banks" (2004), 26.

[481] Ibid., 25.

[482] Hegazy, "Fatwas" (2005), 134.

[483] Unal, "Scholars" (2009), 6; Wigglesworth, "Compliance" (2009), 3.

reason that one of their primary tasks is to report to IFI shareholders, customers and the general public on the extent to which their employer's activities conform to the recognised precepts of the sharia.[484] These intrinsic conflicts of interest continue to overshadow the industry and foster insecurity with respect to the authenticity of Islamic financial products and services.

A great diversity of regulatory approaches to the constitution and operation of sharia supervisory boards exist throughout the Muslim world and in non-Muslim majority jurisdictions such as the United Kingdom. While diversity in regulatory structure is also common amongst conventional financial markets, the lack of uniform sharia standards poses particular problems for the industry inasmuch as the disparate practices of sharia supervisory boards fosters industry-wide uncertainty. Further, the task of the regulator becomes more difficult in that uniform regulatory standards are difficult to achieve in an industry with such great product and operational diversity.

Commercial law, in general, trends toward convergence, but some differences remain, nonetheless.[485] History underscores this fact by demonstrating that market transparency, stability and predictability have proved to be essential principles with respect to the development of commercially viable and prosperous financial centres. Indeed, historically dominant centres of finance and industry such as the United States, England and France have been able to export their commercial and financial law as a result of their incorporation of these principles.

---

[484] Hegazy, "Fatwas" (2005), 138.

[485] See, in general, Foster, "Comparative Commercial Law" (2007).

Specifically, conventional financial transactions generally establish clear parameters with respect to (1) the relative rights and remedies of the parties (2) the terms of many financial and commercial risk allocations and (3) the legal documentation.[486] Therefore, the convergence of international commercial law is designed to mitigate uncertainty and apprehensiveness with respect to these general principles.

Legal standardisation is also a means of alleviating the apprehension legal practitioners feel towards states' conflict of laws rules. Legal practitioners seek to minimise the risks and associated expenses of cross-border financial transactions in the light that they may not be aware of certain applicable foreign laws and/or regulations; and is often a reflection of leading states' ideological and political assumptions that convergence mitigates potential strife and encourages peaceful economic cooperation.[487]

In specific jurisdictions legal documents are typically standardised as they are used for many years and have been the subject of extensive interpretive litigation. Thus "there is great certainty and predictability as to how any particular provision will be interpreted and implemented with respect to the rights, obligations and remedies of all parties in a broad range

---

[486] DeLorenzo and McMillen, "Law" (2007), 152.

[487] Goode et al., *"Transnational"* (2007), 192.

of circumstances".[488] The extensive track record of such standardised documentation has resulted in significant transaction cost efficiencies.[489]

Yet to some extent the principles of stability, predictability and transparency are subjectively based. They refer to an individual's perception of the historical practices of market practitioners and their transactions. The fact that most market practitioners have little or no experience with Islamic financial transactions is an indication of the lack of certainty and predictability that these transactions incur. Moreover, the perceptions of most market actors will understandably be based on conventional structures and financing techniques that take no cognizance of the sharia and differences of risk allocation inherent in Islamic financial structures. These legal disadvantages underpin the commercial drive of Islamic market practitioners and Islamic financial institutions to develop standardised contractual vehicles for the industry.[490] Specifically, greater standardisation would benefit the industry in a number of ways by: (1) reducing transaction costs for firms and thereby lowering prices for consumers; (2) reducing the time necessary for marketing new products; (3) reducing the burden on sharia scholars of which there is clearly a shortage; (4) improving documentation standards and mitigating the risk of legal challenges; (5) by improving consumer confidence in the authenticity of Islamic financial products and services.[491] Indeed, in the United Kingdom, surveys of potential Muslim investors

---

[488] DeLorenzo and McMillen, "Law" (2007), 152.

[489] Ibid., 15.

[490] Ibid., 153.

[491] Treasury, "Development" (2008), 19.

indicate that the scant take-up of retail Islamic financial products is a direct consequence of their uncertainty about the sharia-authenticity of Islamic financial products.[492]

National courts will give legal effect to standardised terms and conditions developed under the auspices of trade and professional associations such as the International Chamber of Commerce (ICC).[493] The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) – which is responsible for issuing uniform sharia accounting and auditing standards in view of creating more transparency in the industry[494] - presents this type of collective standardisation effort. AAOIFI has successfully enacted 41 sharia standards to date, many of which have been adopted and implemented in Islamic financial institutions across the globe.[495] Bahrain, Sudan, Jordan, Malaysia, Qatar and Saudi Arabia have made them either mandatory or recommended guidelines.[496] Quite substantial progress has been achieved over the past two decades in creating a general set of core products and services,[497] which are sometimes referred to as plain vanilla products. Despite these gains, however, IFIs have not consistently adopted AAOIFI sharia standards, with the result that Islamic finance continues to be practiced differently between jurisdictions and even within the same jurisdiction.[498] The challenges of

---

[492] MCB, "Consultation" (2008), 5.

[493] Muchlinski, "Bukowina" (1997), 87.

[494] Sorenson, "Money" (2008), 654.

[495] AAOIFI, "New Standards" (2011).

[496] Askari et al., *"New Issues"* (2009), 33.

[497] Euromoney, "Debate" (2008).

[498] Some of the largest differences in practice exist between the two main centres of Islamic finance, Malaysia and the GCC states. Malaysian jurisprudence, largely based on the Shafi'i school, is viewed as

developing institutions to standardise accounting, regulatory and sharia standards is daunting not merely due to the industry's weak financial architecture but also due to the large degree of political consensus amongst sovereign financial authorities necessary to agree such standards.[499] Negotiating agreed standards remains one of the primary objectives amongst Islamic financial architects.

In Malaysia[500] – a country in which centralised sharia supervisory boards are part of the financial infrastructure – legal standardisation has resulted in *sukuk* becoming cheaper than their conventional counterparts by 5 to 10 basis points as inefficiency has been reduced.[501] However, most analysts believe that the industry will continue to be plagued by differences of opinion on the finer points of the sharia. At present, Malaysian scholars are seen as more liberal than their Gulf peers. And intra-regionally there are just as many differences of opinion. Moreover, the global financial crisis has coincided with a reassessment in some more conservative quarters

---

considerably more liberal than the law of Islamic finance practiced in the Gulf. The more conservative Ḥanbalī school is predominant in the Islamic financial jurisprudence of the Gulf, although the Hanafi and Maliki schools of law also play substantial roles.

[499] Henry, "Dialectics" (2006), 156.

[500] Malaysia and Bahrain are notable exceptions in that these states have created the institutional frameworks for Islamic finance to flourish. For example, Malaysia enacted the Islamic Banking Act in 1983 and the Takaful (insurance) Act of 1984; and created a dual banking system that includes an Islamic inter-bank money market and an Islamic capital markets regulatory authority. While the country continues to be governed by the common law, it has constructed an Islamic legal and financial space that permits the industry to develop – more or less - on its own terms. See Balala, "*Theory and Practice"* (2011), 162-63. Malaysia houses centralised sharia boards within its central bank and securities commission. Bahrain, on the other hand, has given statutory effect to AAOIFI sharia standards, effectively nationalising the standards and guidelines that this international Islamic organisation agrees.

[501] Brown, "Inefficiency" (2009), 5.

whether the industry's rapid expansion and innovation has led it beyond central Islamic precepts. In late 2007 Sheikh Taqi Usmani – one of the industry's most respected scholars – argued that many *sukuk* went too far in mimicking conventional, interest-bearing products, a topic that is analysed in chapter ten.[502] In April 2009 the International Islamic *Fiqh* Academy ruled that the "organised use" of the *tawarruq* financial instrument was prohibited, in what many experts have described as a blow to Islamic banks, as these use them on an almost daily basis for liquidity management and lending. Indeed, a growing number of people are unhappy with the direction Islamic finance has taken and this has resulted in a splintered market of smaller, less viable regional industries.[503]

Transnational financial institutions' dominance of the industry places acute pressures upon the industry to standardise the sharia. However, standardisation may conflict with the contingent attribute that is integral to the religious dimension of the sharia. While it is true that all commercial and financial law trends towards convergence, Islamic financial transactions remain relatively new and untested in courts. Market uncertainty and unpredictability regarding these structures would be ameliorated to the extent that Islamic financial products and services are standardised. In the following section the strategy for transforming the sharia into the Law of Islamic Finance is examined.

---

[502] Wigglesworth, "Compliance" (2009), 3.

[503] Wigglesworth, "Tawarruq" (2009), 3.

4.7 ISLAMIC FINANCIAL IJTIHĀD

The central strategy for devising sharia-compatible financial contracts is undertaken by locating suitable commercial contracts from classical literature and adapting these to mimic conventional financial practices. There has been very little departure from the practices of conventional finance and the types of products and services it offers.[504] However, it is important to note that the vast majority of financial instruments – both conventional and Islamic – are not revolutionary new instruments but merely combinations of older generation derivatives or standard money market contractual vehicles. A building block approach towards financial engineering is at the heart of finance; creativity is not about inventing products from scratch. Indeed, in the conventional financial industry four key financial instruments may be combined in various forms and guises to create all other financial products. These foundational products are the forward contract, the option contract, the deposit contract, and the spot contract. A small number of highly exotic financial instruments are regarded as examples of "accounting innovation" or "ignorance innovation" and possess limited utility for end-users. However, most utilised financial instruments can be broken down into one or another combination of the four mentioned products.[505]

One central reason lies behind the IF industry's conventional approximation: the industry seeks to be competitive with conventional finance. Muslim consumers/investors of Islamic financial

---

[504] Tripp, "*Moral Economy*" (2006), 143-44.

[505] Edwardes, "*Instruments*" (2000), 44.

products demand the same competitive returns that conventional financial institutions offer their clientele. The focus of the Islamic finance industry has been on "the application of a new product or a technology to a specific market opportunity, such as a lifestyle"[506] or addressing socio-economic problems such as directing capital towards small- and medium-sized businesses. Islamic finance has innovated by developing products that cater to the "niche demands" of particular groups of customers.[507]

The free market is the force that determines this strategy. The low-cost ease of access through the internet has driven firms to innovate new financial products that meet the changing needs of the marketplace. Banks, in particular, usually adopt a needs-driven approach in seeking to provide their clients with better solutions to their problems. Firms which are not successful in creating novel structures to meet these needs generally fail.[508] For example, evidence suggests that IFIs, which choose to offer less competitive, but perhaps more sharia-authentic contracts, i.e. those that are perceived to have a closer connection with classical commercial structures, would probably see their clientele exit for more profitable investments.[509] As examined in the previous section, competitive financial transactions are those that have the lowest transaction costs. Lower transaction costs translate into higher rents. The origins of these costs and Islamic finance's particular disadvantages *vis-a-vis* conventional transactions have been

---

[506] DiVanna and Sreih, "*Islamic Finance"* (2009), 47.

[507] Ibid.

[508] Edwardes, "*Instruments"* (2000), 8-28.

[509] A recent survey indicates this fact. See Ernst & Young, "Report" (2008).

reviewed. Cost pressures associated with Islamic financial transactions have resulted in an industry-wide push to standardise Islamic financial products and services.

The legal tools used to achieve these economic objectives are represented in the practice of Islamic financial *ijtihād.* Islamic financial *ijtihād* is a modern form of collective *ijtihād*[510] used to adapt classical sharia contracts and rules to modern financial markets and regulatory requirements. Legal theory provides that any form of *ijtihād* should be exercised sparingly and then only in those instances in which novel legal problems arise. In financial practice, however, the term has a much broader application. It includes those instances in which scholars choose from a range of past opinions (*takhayyur*), irrespective of the school of law to which the jurist belongs,[511] deemed to be of benefit (*maṣlaḥah*) for the Muslim community.[512] Further, it includes an unprecedented utilisation of rationalising legal tools and *ḥiyal* to make transactions lawful that otherwise transgress classical sharia norms and procedures.

Islamic financial *ijtihād* does not represent an effort to conceive an independent legal theory. Rather it is a legal practice designed to create an LIF that retains a legal, if not organic, connection to the legal doctrines and historical traditions of the classical sharia. In fact, it has never been the objective of Islamic financial theorisers to replace the classical law or its legal theory. Instead, their deeply conservative strategy has tried to give effect to classical sharia

---

[510] See Hasan, "Ijtihād" (n.d.).

[511] These may even be Shi'a school doctrines. See Johnston, "Maqasid" (2007), 159.

[512] Vogel and Hayes, *"Islamic Law"* (1998), 40-41.

after a lapse in the modern era in which Islamic civilisation is perceived to have declined.[513] There is a tacit, if not explicit, understanding that the traditional edifice of the sharia is not only suitable for all times and places but the principal determinant in restoring the moral, financial and social successes of the Islamic world.[514] Therefore, Islamic financial theorisers[515] intentionally associate the LIF with the "rationalising discourse" of the *uṣūl al-fiqh.*[516] This is an inference to the fact that the *uṣūl al-fiqh* was formulated several centuries after the genesis of Islamic law. Therefore, the *uṣūl al-fiqh* did not play a role in formulating a large body of Islamic jurisprudence. The degree to which it contributed thereafter is an open debate. The *uṣūl al-fiqh,* as examined in chapter two, embodies Islamic religious and political legitimacy. It is a concept that exerts a powerful historical legacy. Tightly bound to the holy sources, the Quran, Sunna, *'ijmā'* and *qiyās*, it offers a pathway for discerning God's intentions. The historical and religious importance of the concept essentially means that "any conception of the law [sharia], however ultimately defined, must rest on and presuppose a consciously formulated legal methodology".[517] Despite Islamic finance's acceptance and apparent adherence to this tradition, the LIF constitutes a novel and innovative law that markedly distinguishes it from the classical sharia. Yet the LIF's theorisers have not sought to formulate a distinct legal theory as this would disassociate the law from the historical legacy of the sharia.

---

[513] Ibid., 26.

[514] Ibid.

[515] This includes sharia scholars, Islamic finance practitioners and lawyers trained in Western-style law.

[516] See chapter two for a discussion of the *uṣūl al-fiqh*.

[517] Hallaq, *"Sharia"* (2009), 502.

The LIF's divergence from the classical sharia can be ascribed, in part, to the heavy emphasis and frequency given to the application of rationalist legal tools in a legal and financial environment wholly foreign to classical commercial law. These include *maṣlaḥah, takhayyur, ḍarūrah*, and *ḥiyal*. However, it is uncertain whether these concepts are used more often or with greater scope than in the classical period; while evidence of their historical use is limited, available evidence indicates that these tools were probably used frequently according to the imperatives of the classical commercial environment. Subsequent chapters demonstrate, however, that the radical changes of the modern world, including market competition and a complex process of pluralistic legal and regulatory interaction, would seem to require a heavier and more frequent use of these concepts than in the classical era.

In modern financial markets Islamic legal tools are the means of adapting and extending the law. *Maṣlaḥah*, in particular, is an underlying conceptual tool of the LIF, but theorisers decided to narrow its application according to the procedures of the *uṣūl al-fiqh*. The standard approach of doing so resides in incorporating the concept in the procedure of *qiyās*.[518] Al-Ghazālī provides the template for this method. He determined that *maṣlaḥah* had to be defined in order to be used in setting aside revealed laws. If *maṣlaḥah* could be determined with certainty to pertain to the essential elements of the law – religion, life, intellect, offspring and property – then a scriptural ruling could be set aside. However, if *maṣlaḥah* concerned a need (*haja*) or

[518] Opwis, "Maslaha" (2005), 193.

improvement (*tahsin*) with regard to the five elements (*maqāṣid al-Sharia*) of the law, then its application was unacceptable.[519]

This limited approach to *maṣlaḥah* provides a marked contrast to early 14th/19th century jurists, such as Muhammad Rashīd Riḍā and Jamāl al-Dīn al-Qāsimī (1866-1914), whose use of *maṣlaḥah* was premised on abandoning the classical Islamic tradition in favour of directly interpreting the textual sources, the Quran and Sunna. *Ijtihād* was to be practiced as the principal means of reviving Islamic law.[520] This essentially meant that *maṣlaḥah* was to form the basis of legislation for establishing truth and justice in society. *Maṣlaḥah* was viewed as an independent standard in its own right. As opposed to the *uṣūl's* rigid procedures and logically coherent methods of extracting the law from the four formal sources, modern rationalists were less concerned with the manner in which the law was to be found. Instead, the jurist's *fatwa* was to conform to the underlying ethical purpose of the law – however abstract a notion this may be – in order to be legally valid. Legal certainty or the ability to validly discern God's law was to be achieved by mapping the legal ruling to the law's underlying ethical purpose.[521] Hence this conception of *maṣlaḥah* indicates that reformists perceived the human intellect as capable of discerning it as a concrete and objective criterion – a marked departure from the Ash'ari theological tradition.[522]

---

[519] Ibid., 194.

[520] Ibid., 187.

[521] Ibid., 192.

[522] Opwis, "Islamic Law" (2007), 70.

Maṣlaḥah is used to adapt the sharia so as to achieve Islamic financial structures that are competitive in financial markets; such structures have no classical antecedent. Yet the concept is applied narrowly in the procedure of *qiyās* in line with the tradition of al-Ghazālī. The use of *qiyās* in this respect is capable of producing contemporary transactions from classical nominate contracts that do not fulfil the condition of materiality required by the *uṣūl al-fiqh*.[523] Such is the case, for example, when jurists approve of the novel concepts of copyright and patents despite their immaterial attributes.[524] In cases when *qiyās* is not able to meet the modern needs of the Muslim faithful, *ḍarūrah* can be invoked to circumvent a general prohibition.[525]

Furthermore, the application of diverse minority opinions (*takhayyur*) is probably unusual in the sense that the dominant opinions of the classical *madhhab*s became known as established, positive doctrine in the geographical area represented by the school.[526] *Talfīq* (literally, patching) is a related principle which draws upon *takhayyur's* facility of eclectic choice, and is practised in the engineered products of Islamic finance. The principle of *Talfīq* is of much more ancient origins. *Talfīq* is surmised to have first been debated after *taqlīd* (conformity) became the juristic modus operandi; in other words, around the end of the 4th century A.H., after the closing of the "gates of *ijtihād*". A widespread definition emphasises the scholar's role in bringing "forward a fashion [rule of law] that no qualified legal interpreter teaches (*bi-kayfīyah la yaqūl bihā*

---

[523] Ahmed, "*Product"* (2011), 48.

[524] Ibid.

[525] Ibid., 167.

[526] Hallaq, "*Authority"* (2001), 121.

mujtahid)"; in essence a number of opinions of different schools can be taken together to form a novel opinion.[527]

Takhayyur was first put to systematic use in the compilation of the *Majalla*, which was completed in 1876.[528] The principle of *takhayyur* has expanded progressively in scope, and has proved to be the major expedient in the modernising legislative reforms throughout the Muslim world.[529] Whereas the *Majalla* included minority opinions from the Ḥanafī school, and at least one well-known Ḥanbalī opinion,[530] modernists extended the scope of this principle to include any opinion put forward from any Sunni school; or even to doctrines advocated by the early jurists prior to the formulation of the *madhhabs;* or to school doctrines which have since become extinct such as the Ẓāhirīs. On some occasions modernisers have even attempted to invoke Shi'i opinions, although these have seldom been expressly acknowledged in regard to legislation promulgated in a Muslim-majority country.[531]

Adherence to the classical tradition represents a formalistic approach to the law which adheres to legal theory but diverges from the ethical and religious substance of the sharia over time. Widely decried for its "sharia arbitrage"[532] and religious formalistic attributes[533] critics argue that

---

[527] Krawietz, "Talfiq" (2002), 7.

[528] See ibid.

[529] Anderson, "*Law Reform"* (1976), 47-48.

[530] Arabi, "(Shurut)" (1998), 31.

[531] Anderson, "*Law Reform"* (1976), 51.

[532] El-Gamal is a well-known proponent of this wholly valid criticism. See El-Gamal, "*Islamic Finance"* (2006).

Islamic financial *ijtihād* is devoted "to the creation of elaborate forms of potentially deceptive artifices in order to circumvent prohibitions derived under otherwise unworkable Islamic rules, most importantly those concerning interest on debt and forms of speculative risk".[534] This line of reasoning argues that scholars should adopt a rationalist approach that emphasises experiential context and real-life human interaction, aided by the legal tools that modernist reformers espouse.[535] A substantive rationalist approach[536] to the law would necessarily lead to a wholesale revision of Sunni Islamic jurisprudence, notwithstanding the financially relevant prohibitions of *ribā* and *gharar*.[537] As suggested in the introductory chapter, however, the majority of Muslims across the globe would not readily agree to a re-interpretation of these historical doctrines. A rationalist approach to financial *ijtihād* is unlikely to be perceived as a legitimate and authoritative interpretation of the holy sources.

CONCLUDING REMARKS

The modern use and perception of money has fundamentally altered the social, economic and legal environment of communities across the globe. The value of money is no longer attached

---

[533] See Hamoudi, "Social Justice" (2007).; Hamoudi, "Schizophrenia" (2006-2007).

[534] Hamoudi, "Revolution" (2007-2008), 258.

[535] Hamoudi, "Schizophrenia" (2006-2007), 607, 11.

[536] This is the term used by Opwis to describe a theoretical approach that emphasises ethical compatibility with a legal ruling. See Opwis, "Maslaha" (2005).

[537] El-Gamal, "Ribā " (2001). Gamal argues that *ribā* should be seen in terms of efficiency rather than as a matter of exploitation by the strong of the weak and vulnerable. For his work on re-interpreting *gharar* see El-Gamal, "Gharar" (2001).

to the coinage in which it is exchanged. Rather it has come to represent the ideal signification of value; the embodiment of a representative value that is as much a psychological phenomenon as an economic one.

Money's altered role in the modern world is epitomised in the financialisation of the world capitalist economy. The predominance of finance over the real economy fundamentally undermines the social and economic basis of Islam's prescriptions for avoiding *ribā.* Modern Muslim authors perceived this danger and wrote fervently of the evils that capitalism and secularism posed for the Muslim world. In particular, capitalism threatened the spiritual and communitarian coherence of Islamic life.

Nearly the entire Muslim world witnessed the displacement of the sharia in the wake of 19th century European economic dominance and colonial imposition. Islamic economics is a largely qualitative response to Islam's devaluated role in the Muslim world. It represents an economic and social trend that reasserted the moral primacy of Islam in economic life. Islam alone could provide a moral filter for the economy that shunned excess, greed and immorality; the materialism of the West and its concomitant secularist values. Islamic finance was viewed as a way of gradually implementing an Islamic economy. The sharia and its prescriptions for financial transactions is the natural vehicle of modern Islamic finance. In particular, the Islamic bank was conceived on the basis of the *muḍārabah* partnership contract.

The rapid growth and development of Islamic finance is evident in the fact that it is represented in over 70 jurisdictions across the globe. Transnational financial institutions have joined the fray and now dominate the industry. The industry's push to standardise Islamic financial contracts and practices reflects the commercial prerogatives of lowering transaction costs associated with the uncertainty and unpredictability of Islamic financial structures.

The central animus underlying the effort to adapt the sharia to modern financial markets and regulatory architectures resides in the industry's drive to offer competitive investment returns. This requires the industry to find ways in which transaction costs can be reduced. Essentially, the strategy is to adapt classical financial structures to conventional financial products and services.

The theorisers of Islamic finance expressly associate the LIF with the classical legal theory known as *uṣūl al-fiqh.* This is due to the *uṣūl's* authoritative and legitimising role in helping jurists to discover God's law. Islamic financial theorisers believe that the *uṣūl* and the traditions – if not the rules – of classical jurisprudence (*fiqh)* are applicable for all times and circumstances. Islamic financial *ijtihād* is the strategy for creating the Law of Islamic Finance, a law that is clearly distinguishable from the sharia. In part, it is distinguishable by the types of tools utilised and the frequency of their application. The principal factor, however, relates to the LIF's wholesale adaptation to market forces and regulatory requirements.

Maṣlaḥah, *takhayyur* and *ḍarūrah* are the principal legal tools used to adapt the sharia to modern financial markets. Yet theorisers' pursuit of a narrow application of *maṣlaḥah* in the procedure of *qiyās* represents a formalistic approach to the law that is consistent with classical theory. Modern authors decry this approach. They criticise the LIF's formalistic attributes and inefficient contractual structures. They favour a rationalist approach to the law that stresses religious and ethical substance.

In the following chapter several important Islamic financial contracts are analysed. The analysis is concerned with the way in which Islamic financial *ijtihād* has been applied to these structures. It is also concerned with some municipal legal considerations that may arise in conjunction with them.

CHAPTER FIVE: MODERN ISLAMIC FINANCIAL PRODUCTS

INTRODUCTION

This chapter examines several Islamic financial contracts that are the product of Islamic financial *ijtihād*. It considers the way in which Islamic financial *ijtihād* is used as well as the municipal legal challenges that arise in conjunction with these structures.

In particular, the chapter is concerned with three pivotal products used by the industry: the modern *murābaḥah*, the *tawarruq* and the *sukuk*. Conventional securitisations are also examined so as to better conceptualise the structure, attributes and legal uncertainties that characterise *sukuk* securitisations. Finally, a debate concerning the authenticity of *sukuk* issuance is considered, which provides a significant example of the principal legal issues encountered in the exercise of Islamic financial *ijtihād*.

5.1 THE MODERN MURĀBAḤAH

The *murābaḥah*, a debt-based contract used for financing, is a particularly important contract in the Islamic financial industry. It comprises approximately 80% of a typical IFI's balance sheet.[538] The classical *murābaḥah* was a spot sale of a good with a clearly disclosed profit

[538] Ahmed, "Islamic Law" (2006), 88-89. DeLorenzo, "Compliance" (2006-2007), 406.

margin. In that structure the initial price had to be known to the buyer as well as the profit margin.[539] It was a rather simple and straightforward means of avoiding the prohibition of *ribā*.[540]

The modern *murābaḥah* is used to finance household items, cars or business equipment and/or supplies. It is often used to replicate a conventional trade financing agreement. In this contract the client approaches an Islamic financial institution and requests that the IFI purchase a commodity on her behalf for a clearly specified cost and profit. Second, the IFI contacts a seller and purchases the commodity. The IFI takes possession and ownership of the commodity and thus assumes risk of loss or damage to the goods. Third, the IFI sells the commodity to the client for a profit, usually on a deferred payment basis. Finally, the sale is concluded and the ownership, along with the risk of the commodity, is transferred automatically to the client.

The modern *murābaḥah* resembles the economic substance of a conventional trade finance agreement with documentary credits. These provide the seller (S) with security that it will be paid the purchase price of a good; and they reassure the purchaser (P) that the goods exist, that they have been shipped, insured and sometimes quality-checked. It is undertaken as follows: The first step involves P, who enters into a supply agreement with a seller for purchase of a particular good/goods. P then applies to his bank (IB – issuing bank) to open a credit in favour of S. IB issues a letter of credit to S undertaking to pay "a sum equal to the contract

---

[539] Al-Zuhayli, *"Transactions"* (2003), 355.

[540] Usmani, "*Introduction"* (2002), 31-32, 37.

price or payment, acceptance or negotiation of a bill of exchange drawn for that sum". IB is not concerned with the underlying contract of sale. It merely acts on P's instructions. IB may directly issue a letter of credit but more often it arranges for notification by another bank, known as an advising bank (AB). AB will be located in the country of the seller and will advise S of the opening of credit in his favour. The notification given by AB constitutes the documentary credit.[541]

Banks are not in the business of selling merchandise and so the Islamic financial institution will not own the good which the buyer wishes to purchase. Yet, the Islamic laws of contract forbids the sale of an item not yet owned by the seller, and has a complex set of rules regarding the seller's constructive and actual possession of such goods. The solution is to compose the *murābaḥah* of two binding contracts which are to be executed independently of one another. Arguably, this kind of combination of classical nominate contracts to effect a single economic objective is the single most important method of Islamic financial engineering; without it, modern Islamic banking and finance would not be possible.

In the first instance, the initial purchase agreement, a "binding promise" (*wa'ad*), is executed.[542] Such "promises" are enforceable in both Muslim and non-Muslim majority jurisdictions. However, classical jurisprudence generally does not recognise the validity of a binding 'promise to purchase' as this transgresses the sharia. Namely, a "promise to purchase" an item not yet in

---

[541] Goode, "*Commercial Law"* (2010), 1062-65.

[542] Moghul and Ahmed, "Contractual Forms" (2003-2004), 174-175.

existence, whose price is unknown, and which the buyer has not yet seen, violates the very essence of the prohibition of *gharar*.[543] Moreover, the inclusion of a binding promise agreement violates the prohibition of "two contracts in one" or "two sales in one contract".[544]

While most of the great eponyms of the Sunni orthodox schools of law, al-Shāfiʿi, Ibn Ḥanbal, and Abu Ḥanafī viewed the fulfilment of such promises as a noble quality and thus as advisable for the promisor to fulfil, they regarded them as neither mandatory (*wājib*), nor enforceable through the courts.[545] Judge Muhammad Taqi Usmani, however, finds proof of the binding nature of the promise amongst the opinions of a number of jurists. This is the view, argues Usmani, of Samurah bin Jundub – the well known companion of the Prophet – as well as of 'Umar bin Abdul Aziz, Ḥasan al-Baṣrī, Sa'id bin al-Ashwā', Isḥāq bin Rahwaih and Imam al-Bukhārī, some Mālikī jurists, and even the great Shāfiʿi philosopher-jurist al-Ghazālī, who said that a promise was binding as long as it was stated in absolute terms.[546] Other jurists and IFIs have accepted an opinion from the jurist Ibn Shubruma, a relatively less well-known Mālikī jurist.[547] According to Ibn Shubruma the promise is binding when it does not result in allowing that which is forbidden or forbidding that which is permitted.[548] In other words, the *murābaḥah's* legal justification relies on the adoption of diverse opinions (*takhayyur*).

---

[543] Ray, "*Renewal"* (1995), 51.

[544] El-Gamal, *"Islamic Finance"* (2006), 99.

[545] Usmani, "*Introduction"* (2002), 50.

[546] Ibid.

[547] El-Gamal, *"Islamic Finance"* (2006), 66.

[548] Al-Zuhayli, *"Transactions"* (2003), 361.

The highly-respected Islamic *Fiqh* Academy's decision that a promise made in commercial or financial transactions is binding on the promisor confirms this modern application of *takhayyur*. Its decision stipulated that the following conditions are necessary for a valid *murābaḥah*: (1) the promise should be unilateral, i.e. performance cannot be made contingent upon the execution of another contract; (2) it must have led the promisee (the seller or lessor) to have incurred costs; (3) if the promise relates to the purchase of an item in the future, the parties must enter into an actual contract of sale only at that time; and (4), if the promisor (the buyer) breaks his promise, the promisee may seek a remedy in court for damages or specific performance. Damages are confined to actual monetary loss by the promisee (IFI) and do not include the opportunity cost of the money in question.[549]

The risk that the buyer may nonetheless refuse to make the purchase is reduced by requiring security in the form of a promissory note or third party guarantee. Some IFIs have required security well in advance of the purchase and in an amount that would cover any losses that may arise from the buyer's refusal to purchase.[550]

Returning to the second step of the *murābaḥah* schematic, the bank's purchase of the commodity from a third-party supplier for re-sale to the client does not usually live up to sharia rules concerning the conclusion of a valid contract of sale. In some cases, the sale of a

---

[549] Uberoi et al., "Wa'ad" (n.d.).

[550] Moghul and Ahmed, "Contractual Forms" (2003-2004), 181.

commodity is completed before its acquisition from the supplier, often in circumstances in which contractual documents are signed in quick-fire succession. In this case, the IFI assumes little or no risk in the ownership of the commodity as its ownership lasts, literally, seconds. Although this manner of executing the *murābaḥah* is criticised by jurists, the practice predominates throughout the industry.

Ownership of the good ensures that the IFI assumes risk in the commodity, including liability for potential damage, defects or outright loss. Any inherent defect in the article sold transfers an unconditional right of rescission of the contract, an option of fault (*khiyār al-'ayb*) to the buyer.[551] According to classical jurisprudence, such a stipulation cannot be waived by the buyer, as it is an essential component of the contract of sale. The option of fault highlights the essence of certainty in the Islamic law of contracts; any exclusion of its provisions is, in itself, a nullity.[552] The prevalent industry practice excludes the option of fault and the right to rescind the sale so that the IFI is insulated from these commercial risks.[553] For example, the Kuwaiti Finance House, stipulated in its contracts of sale that any defect in the object of sale, excluding insufficiency in the number of items shipped, is to be borne by the buyer.[554]

Banks have attempted to circumvent ownership requirements by appointing clients (buyers) to purchase the commodity as agents of the bank (*wakīl*). This scheme would likely have been

---

[551] Al-Zuhayli, *"Transactions"* (2003), 200-01.

[552] Coulson, *"Commercial Law"* (1984), 66.

[553] Moghul and Ahmed, "Contractual Forms" (2003-2004), 181.

[554] Ray, *"Renewal"* (1995), 49.

forbidden by Ḥanafī, Shāfiʿi and some Mālikī jurists on account of the prohibition of creating a contract which is contingent upon the fulfilment of another. Modern jurists, while expressing reservations concerning the practice, deem it valid on the basis of necessity (*ḍarūrah*) and on condition that the steps are carried out individually and in consecutive fashion.[555]

Another widespread practice makes the buyer not merely responsible for defects in the commodity, but assigns to the buyer liability for the shipment and "the actions of the exporter".[556] This effectively indemnifies the seller from any liability relating to the goods, indicating that the parties did not intend the transaction to be a contract of sale. Like a documentary letter of credit the financial institution removes the risk and inconvenience of the transaction by limiting its participation to the documents relating to the sale.[557] Despite its non-compliance with the sharia, this type of indemnity is a standard practice. In fact, the commercial feasibility of transacting in *murābaḥah* structures without such clauses is precarious[558] and very few, if any, IFIs would be willing to transact in them.[559] These provisions, however, would almost certainly fall foul of the UK Sale of Goods Act 1979; in particular, section 12 (2)(b) provides that there is an implied term that "the buyer will enjoy quiet possession of the goods except so far as it may

---

[555] Usmani, "*Introduction"* (2002), 67.

[556] Ray, *"Renewal"* (1995), 49.

[557] Chuah, "Morabaha" (2006-2007), 161.

[558] Ibid., 162.

[559] Bälz, "Murabaha" (2004), 126 . This also pertains to conventional trade finance. The difference is that conventional trade finance does not attempt to cloak the transaction in the garb of a contract of sale. The issuing bank does not assume liability for the good(s) supplied by the seller because its carefully circumscribed role is merely to finance a supply contract agreed by the parties.

be disturbed by the owner or other person entitled to the benefit of any charge or encumbrance so disclosed or known".[560] Parties may not waive the implied terms to title, including rules providing for the buyer's quiet possession, and others concerning the description and satisfactory quality of the good(s).[561]

Furthermore, section 6 (3) of the Unfair Contract Terms Act 1977 provides that liability in non-consumer contracts of sale "[…] can be excluded or restricted to a contract term, but only in so far as the term satisfies the requirement of reasonableness".[562] The reasonableness test concerns the relative bargaining positions of the parties; whether the customer received any inducements to agree to the terms; whether costumers should have known of the existence and scope of a specific term, and other conditions.[563]

The extent of the Unfair Contract Terms Act 1977 is limited by section 26(1), which provides that: "A person may exclude or restrict liability by reference to a contract term do not apply to liability arising under [international supply contracts]".[564] International supply contracts are qualified as those that are "made by parties whose places of business (or, if they have none, habitual residences) are in the territories of different States".[565] Where the Unfair Contract

---

[560] Sale of Goods Act 1979. This is the opinion of Chuah, "Morabaha" (2006-2007), 162-163.

[561] Chuah, "Morabaha" (2006-2007), 163.

[562] The Unfair Contract Terms Act 1977, s 6, s-sub. 3. See schedule 2 for guidelines for application of reasonableness test.

[563] Ibid., sch 2.

[564] Ibid., s 1. See s 26(3) for a description of that contract.

[565] Ibid., s 26(3)(b).

Terms Act 1977 does not apply, the terms of the contract are not subject to the requirement of reasonableness. Furthermore, the common law, which does not have a reasonableness test, will approach the validity of excluding or limiting a liability clause as a matter of construction.[566] As most *murābaḥah* are transacted between contracting parties located in the same state, however, the exclusion in section 26 of the Unfair Contract Terms Act would not apply. In that event the contract would be subject to a reasonableness test.[567]

The *murābaḥah* presents a vivid example of the Islamic concepts and tools used to adapt the classical mark-up structure to mimic conventional financing techniques. The modern structure does not evince the ownership requirements of the sharia, and yet few IFIs would be willing to transact in them, if they were forced to assume these requirements. Furthermore, various indemnities associated with the transaction may fall foul of statutory law, although international supply contracts are excluded. The next section examines the use of the *tawarruq* as a financing technique at the Islamic Bank of Britain.

---

[566] See *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827. The House of Lords held that "the doctrine of fundamental breach by virtue of which the termination of a contract brought it, and, with it, any exclusion clause to an end was not good law; that the question whether and to what extent an exclusion clause was to be applied to any breach of contract was a matter of construction of the contract and normally when the parties were bargaining on equal terms they should be free to apportion the risks as they thought fit, making provision for their respective risks according to the terms they chose to agree".

[567] Chuah, "Morabaha" (2006-2007), 165.

5.2 TAWARRUQ

Tawarruq is a modified version of the *bay' al-'inah* group of sales which involve a same-item sale-repurchase with a third party intermediary. The *tawarruq* is used on an almost daily basis by IFIs to generate liquidity for clients' business needs and to facilitate inter-bank lending. The underlying *bay' al-'inah* structure is designed accordingly: a "borrower" sells some property to the "lender" and receives its cash price in return; the "lender" then turns around and re-sells the same property to the "borrower" on credit and at a higher price equal to the cash price plus interest. Abū Ḥanīfah ruled that the validity of a contract is determined solely by its language. Nonetheless, he agreed that the same-item sale-repurchase without the inclusion of a third party intermediary was defective according to a tradition from Zayd ibn Arqam. Al-Shāfi'i and Ẓahirī jurists deemed the contract valid for the same reason, although they also found the contract extremely reprehensible as it was an obvious stratagem to circumvent the prohibition of *ribā*.[568] In general, proponents of the contract maintain that the validity of contracts is to be examined only through the external manifestation of its contractual parts. The motive (*nīyah*) of the parties is immaterial as to the validity of the contract which they support with the following prophetic Hadith: The Prophet was to have said: "He who jests with the words that will make a binding contract of marriage, or with the words that pronounce a divorce or declare a slave free, shall be taken to have meant the words seriously".[569] Although the Hadith does not deal with commercial affairs or the circumstances in question, supporters rely on Islam's long tradition of

---

[568] El-Gamal, *"Islamic Finance"* (2006), 70-71.

[569] Haneef, "Trends" (2005), 47.

textualism and legal formalism to justify this central claim. However, sharia scholars of the Islamic Bank of Britain have other legal tools at their disposal that would also help to validate the transaction.

The Islamic Bank of Britain (IBB) was established in London in 2004 as the first and only stand-alone Islamic retail bank in the United Kingdom. It offers both secured and unsecured business finance. The IBB claims that its business finance product is structured upon the principles of *murābaḥah* but, in fact, the steps of the transaction resemble those of the repudiated *tawarruq* in modified form. The procedure is as follows:

(1) the client requests a facility for, say, £10,000 to be repaid over 12 months;

(2) the client appoints the bank to act as his agent whereupon the IBB purchases £10,000 of a commodity (usually a metal on the London Metals Exchange) and sells this to the client at a profit (say £10,800 which equals an £800 profit or an 8 percent mark-up);

(3) the client's debt to the bank now totals £10,800 and is due, over the course of instalments, in 12 months (neither the client nor the bank takes delivery or possession of the goods and thus little risk is assumed by either party);

(4) the bank acting on behalf of the client instructs a broker to act as the client's agent (*wakīl*) and sell the commodity on his behalf;

(5) by employing a broker-agent to sell the commodity to a third party buyer on behalf of the client the bank achieves a degree of separation from the immediate sale transaction and so gives the appearance that it does not take a direct role in the re-sale of the commodity;

(6) in a clear conflict of interest, the bank also acts for the broker under a separate power of attorney and arranges for the broker to sell the commodity at its market value, £10,000, resulting in the client's receipt of £10,000 in cash.[570]

The contract represents a rather vivid legal stratagem designed to facilitate business finance. By circumventing the risk of ownership, however, it gives effect to a structure that produces an unjustified enrichment according to the *ribā* doctrine.

Tawarruq plays a pivotal role in meeting consumer and investor financing requirements, and it facilitates financial institutions' interbank liquidity requirements. Although controversial in terms of its economic substance, some schools of law view its legal form as sharia-compatible.

The following section examines a further example of Islamic financial engineering. In particular, the *sukuk* securitisation structure is the central focus.

5.3 SUKUK AND CONVENTIONAL SECURITISATIONS

The *sukuk* represents a vivid example of the way in which practitioners of the Law of Islamic Finance have adapted conventional financial contracts to produce sharia-compatible alternatives. The *sukuk*, although commonly known as an Islamic bond, is perhaps more

---

[570] IBB, "Business Finance" (2006).

appropriately described as an Islamic investment certificate.[571] *Sukuk* certificates represent a holder's proportionate ownership interest in an underlying asset or transaction and thus share characteristics of asset-backed securities and equity investment. However, *sukuk* also share characteristics with unsecured debt securities, which makes it difficult to classify them in any of these categories.[572]

Sukuk[573] are a modern innovation borrowed from the conventional concept of the asset-backed securitisation and designed to replicate the payment profile of conventional bonds. Conventional bonds are mid- to long-term debt instruments in which an investor lends money for a defined period of time and receives a fixed or floating amount of interest income. Bonds have a set maturity date at which time the issuer agrees to pay the holder his principal investment.[574] Bonds bear interest and are not permissible according to the sharia. Furthermore, funds generated from bond issuances are not screened according to sharia criteria and thus could possibly be used for *ḥarām* purposes including alcohol, pornography or highly leveraged corporations.[575]

---

[571] Wilson, "Sukuk Market" (2004), 3.

[572] Richardson, "Integration" (2011), 8.

[573] The modern *sukuk, sg. ṣakk* (the plural form is almost always used) originated from the classical *ṣakk*, an ancient monetary instrument first described in Malik's famous treatise, *al-Muwatta*. In the first Islamic century the Umayyad caliphate would pay soldiers and public servants in cash and in kind. Payment in kind was known as *sukuk al-badā'i '*, something akin to commodity coupons or grain permits. *Ṣakk* holders would produce their certificate upon its maturity date at the treasury and receive a fixed amount of commodity, usually grains. See Haneef, "Trends" (2005), 29.

[574] Rose and Marquis, "*Capital Markets"* (2008), 68.

[575] Wilson, "Sukuk Market" (2004), 5.

A conventional asset-backed securitisation, on the other hand, is a structure that generates profit from the performance of an underlying tangible asset(s), transaction(s) and/or venture(s) and thus meets general sharia requirements concerning the generation of wealth. The following sub-section examines the legal features of conventional securitisations and thus provides background information for a subsequent examination of the *sukuk al-ijārah* or lease-based *sukuk*.

5.3.1 CONVENTIONAL SECURITISATIONS

A securitisation enables an originator (a company, municipality or government) to raise money from investors on the security of receivables. It represents an increasingly important way of raising money from investors in open markets instead of through a traditional financial intermediary such as a bank.[576] A securitisation converts illiquid (non-marketable) assets into tradable, highly liquid (marketable) securities and/or funds. Receivables are the most common type of assets in a securitisation. They represent rights to payment in connection with leased assets, loans to buy real property, unsecured commercial loans and amounts owing on credit cards.[577] Finance is raised by securitising the rights to a particular set of assets that generate predictable income streams. Tradable securities representing the rights to assets or an interest in an asset are sold to generate funds.[578]

---

[576] Rose and Marquis, "*Capital Markets"* (2008), 102.

[577] Balala, *"Theory and Practice"* (2011), 131.

[578] Ibid., 130.

Four principal steps are involved in a securitisation; (1) the owner of receivables, known as the originator, sells them to a special or single-purpose vehicle (SPV). The SPV is a legal entity that is either orphaned (shares are held by third parties; this is usually the case in non-trust countries)[579] and/or owned by a charitable trustee so that it is not financially attached to the originator; (2) The SPV borrows money in a 'funding loan' to finance the purchase of the receivables. The funding loan is later repaid from the proceeds of the further sale of the receivables; (3) the purchaser of the receivables authorises the originator to collect proceeds of the receivables on his behalf and to forward proceeds to the SPV; (4) the SPV grants security over the receivables to the purchasers of the assets. The funding loan is secured by way of a fixed or floating charge over all of the assets of the SPV.[580]

The principal economic objective of securitisations is to enable the originator to raise money from investors on the security of the receivables. The grant of securities enables creditors to force a sale of the property and to apply the proceeds of the sale to the secured debt ahead of other creditors. When a creditor's rights have been realised through the payment of a secured debt, a debtor is released from his obligation.[581] A number of other advantages are also available to originators. For example, the originator continues to retain any surplus from the receivables just as would be the case as if it had granted a security interest such as a mortgage

---

[579] Wood, *"Title Finance"* (1995), 46.

[580] Goode, *Commercial Law*, (2004), 148.

[581] Wood, "*Security and Guarantees"* (1995), 4.

over them. An actual security interest over an asset would require the creditor to retain any surplus not needed for repayment of the secured loan and remit this to the debtor.[582] Furthermore, under a security interest the debtor has the right to the charged collateral upon repayment of his debt.[583] By using "title finance" structures such as *sukuk* the originator is able to retain title to the asset as opposed to having a mortgage over the asset.

This may be particularly relevant to Islamic finance in that some Middle Eastern jurisdictions may not grant non-possessory chattel mortgages due to money-lending or usury laws.[584] For example, mortgages on chattels are currently not possible in Saudi Arabia.[585] The sharia, which is the official law of Saudi Arabia, does not recognise chattel mortgages in that they secure an investor's principal and thus generate an unjustified return (*ribā*). Similarly, the United Arab Emirates, one of the largest markets for Islamic finance, does not permit mortgages on movables. Instead the UAE Commercial Code allows commercial businesses to pledge their businesses while retaining possession of the business. The title to goods in which businesses transact are not able to be pledged. In general, security law in the UAE is underdeveloped and thus prevents lenders from effectively securing transactions.[586]

---

[582] Wood, *"Project Finance"* (2007), 112.

[583] Balala, *"Theory and Practice" (2011),* 137.

[584] Wood, "*Insolvency"* (2007), 365.

[585] Wood, *"Security and Guarantees"* (1995), 7.

[586] Hourani and Fahl, "Securities Law" (2001), 58-61.

In a securitisation the originator is able to transfer the risk of the non-payment of receivables to investors and thus can remove the assets from its balance sheet; the loan becomes a liability of the SPV rather than the originator.[587] Therefore, originators are able to raise money without the loans appearing on its balance sheet and, importantly, retain any surplus profit from the sale of the receivables. Furthermore, the originator (as seller) receives a cash price on the sale of the receivables which can be used to offset liabilities. Hence, both assets and liabilities are removed from its balance sheet and more borrowing room is created. This improves an originator's financial ratios, i.e. its debt to equity ratio – known as gearing. Thus the seller's return on capital is improved in that its assets and liabilities have been removed but it still retains the profit.[588]

Furthermore, the conventional SPV benefits from receiving a higher rate of interest for its sale of the receivables than the securities holders receive in payments comprising principal and interest. The originator ultimately receives the margin of difference from a number of methods of profit extraction, bearing in mind that the risk that the receivables default could frustrate this strategy. Finally, originators benefit from cheaper capital in that securitisations offer a cheaper means of raising finance than that obtained by applying directly for a loan or issuing bonds. Issuance is designed so that junior tranches of notes bear a greater risk of first loss, which enables senior tranches to be rated AAA – the highest rating given – and thereby pay a low rate

---

[587] Wood, *"Project Finance"* (2007), 112.

[588] Wood, *"Title Finance"* (1995), 44.

of interest. Senior tranches are usually higher quality assets than most of the seller's assets and these are insulated from the credit of the seller and are effectively secured.[589]

The realisation of these objectives depends, in large part, on whether a 'true sale' has taken place between the parties. Certain legal thresholds must be met. First, the seller should have no liability for the asset except for providing warranties against defects. Therefore the seller may not guarantee recoverability or have a duty to repurchase the asset, nor provide additional cash transfers or assets. In general, the seller should have no moral duty to note holders to compensate them for shortfalls. Liability would require a seller to clearly state the asset in its balance sheet and retain capital against it. Second, buyers should maintain exclusive control and dominion over the asset, which entitles them to sell or pledge it without consideration of the seller. Therefore, the buyer should be able to collect all profits from the asset without having to transfer these to the seller. Were the seller to retain some degree of control and dominion, the asset may still belong to the seller and be susceptible to its creditors – although this basic principle of private property is somewhat diluted in the case of securitisations. Finally, the sale cannot be revocable upon the insolvency of the purchaser, due either to a preferential transfer – such as whether the form of sale transfers assets at a price below market value - or because the seller is, in fact, the buyer or a part thereof.[590]

---

[589] Wood, *"Project Finance" (2007),* 118.

[590] Ibid., 156.

The key determinant of these criteria consists in whether the risks inherent in the assets has been retained by the originator or has been transferred to the issuer and through the issuer to the note holders. If the risks of the assets have transferred to the SPV – in other words, a true sale has occurred - the originator's creditworthiness is not taken into account as its continued financial health is of no further significance to the transaction. However, in a secured lending structure such as a mortgage– a structure wherein the debtor has the right to receive the charged collateral upon payment of the secured debt as well as any surplus monies in the case that the creditor enforces payment and sells off the collateral - the originator is the borrower and its financial health plays a significant role in any rating of the transaction.[591]

Two principal issues depend on whether a 'true sale' has been effected; (1) the re-characterisation of a 'sale' as a security interest and (2) the concept of bankruptcy remoteness.

A court of law, for the purposes of security law, may re-characterise the transaction as a secured loan by the SPV to the originator so that secured assets would be treated as still belonging to the originator rather than as a true sale of the assets to the SPV. The effects are usually disastrous. Re-characterisation effectively destroys any advantage derived from securitisation so that assets would be listed on the balance sheet of the originator and the purchaser's loan would constitute a liability. Moreover, the transaction would almost certainly

---

[591] Patrick Clancy, "Synthetic Transactions" (2006), 41.

require registration or “perfection by filing” if it is not to be treated as void upon the insolvency of the seller.[592]

Some states require registration of certain transactions and may re-characterise title finance structures as mortgages. Were this to occur, registration buttresses the creditor against a loss of priority – the priority by which creditors’ claims against debtors’ assets are made valid – but would obviate the originator’s advantages in using a title financing structure.[593] Recall that some Middle Eastern jurisdictions do not recognise mortgages over non-possessory chattels and may invalidate a transaction subject to re-characterisation. At present there are no precedents in GCC jurisdictions that offer clues as to the way in which courts in these jurisdictions may approach a *sukuk* issuance with a purchase undertaking.[594]

The principal factors in considering re-characterisation are:[595]

(1) Whether the originator’s rights to repurchase receivables in substance constitute an equity of redemption of mortgaged property, i.e. the mortgagor’s right to get back the mortgaged property on repayment of the loan. The originator may desire a right to

---

[592] Wood, *“Title Finance”* (1995), 53.

[593] Ibid., 12.

[594] Bi, "Transactions” (2011), Q&A session; Hourani and Fahl, "Securities Law” (2001), 55. The Dubai World default event did not provide any indication of how such structures will be construed since note holders of Nakheel *sukuk* were reimbursed prior to the occurrence of judicial proceedings. In any case DIFC (Dubai International Financial Centre) insolvency law, which is principally based on English insolvency legislation, governed the settlement of Dubai World and its subsidiaries. See Bourke, "Dubai World” (2009). See also Salah, "Debt Crisis” (2010).

[595] Wood, *“Title Finance”* (1995), 53-54.

repurchase in order to end the transaction because, e.g. it is too onerous, or enforcement would be damaging, or it is no longer profitable. The originator usually has the right to repurchase small remaining amounts at the end of the financing to mop up the last drops when it is no longer economic to continue.

(2) Whether the extraction of profits by the originator amounts to a lender accounting to the borrower for the excess of the mortgaged property over the loan. In a true sale, the purchaser keeps the residual value (profit) of the purchased property, but in a mortgaged property the borrower receives back the residual value on repayment of the loan.

(3) Sham, i.e. the parties carry out the transaction in a different way than that contemplated by the documents, e.g. the records refer to a loan and interest, not a sale price. The parties need to make sure that this does not happen.

(4) Collections by the originator, i.e. whether the continued collection of the receivables by the originator negates a true sale.

An English common law jurisdiction is not likely to re-characterise a securitisation for the reason that an appropriately documented sale of receivables, which the parties treat as a sale, “is not a loan by the buyer to the seller secured on the receivables requiring registration, even if the buyer has recourse to the seller for unpaid receivables, even if the seller has a right of repurchase (e.g. stub assets at end), even if the profit is paid to the originator (e.g. a servicing fee), even though the seller continues to collect as agent of the purchaser, and even though the

economic effect is similar to a loan secured on the receivables".[596] In England form is given weight over economic substance. Effectively structured transactions are not registrable unless the court dismisses the transaction as a sham – or views it with regard to its substance rather than its form - and converts it into a secured loan or mortgage.[597] Although common law protects investors with equitable doctrines of unconscionable dealings and equitable principles, in general, its focus is on the legal substance of a title finance transaction. For example, in *Welsh Development Agency v Export Finance Co* the Court of Appeal held that the transaction could not be interpreted as a sale of goods or a charge or mortgage on the goods without examining the agreement, and the nature of the legal relationship, as a whole.[598] As long as the transaction is what parties claim it is, and not a guise for something else, the court is disinterested in whether the transaction has been structured as a sale or a loan. Form over substance is firmly established with respect to many authoritative cases relating to title finance in English courts.[599] This obviously represents a particularly amenable legal environment to Islamic finance and it is thus not surprising that many Islamic financial transactions are governed according to English law.

---

[596] Ibid., 54-55.

[597] Ibid., 12.

[598] *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148.

[599] See *Olds Discount Co Ltd v John Playfair Ltd* [1938] 3 All ER 275. *Re George Inglefield Ltd*, [1933] Ch. 1. *Lloyds and Scottish Finance Ltd v Prentice* [1977] 121 Sol Jo 847; *Welsh Development Agency v Export Finance Co Ltd*. And *Mahonia Ltd v JP Morgan Chase* [2004] EWHC 1938.

The second principle issue of 'bankruptcy remoteness' also depends on whether the agreement can be described as a 'true sale'. Bankruptcy remoteness from the originator is established when the securitisation is able to withstand the originator's insolvency. For this to occur the SPV must be made wholly independent of the originator so that the bankruptcy of the originator would not be tied to the assets and liabilities of the SPV. The purchaser SPV should not be consolidated on the balance sheet of the originator. The separateness of the SPV is strengthened by applying the rules pertaining to the piercing of the veil of incorporation. These include the provision of separate officers, no commingling of assets, separate records, the observance of corporate procedures, financial statement disclosure and so forth. Furthermore, the seller's transfer of payments to the SPV "may not be capable of being set aside as a preference" or undervalued on the bankruptcy of the seller.[600] Were payments or other transfers set aside, creditors of the originator would have a claim against the receivables. This rule pertains to the original sale of the assets to the SPV and subsequent (asset) substitutions by the originator.[601]

5.3.2 SUKUK

Recall that a conventional bond entitles a bondholder to receive regular interest payments during the life of the bond from the bond issuer and the principal investment upon maturity of the bond. Bondholders are creditors to the bond issuer and are ranked as senior unsecured and

---

[600] Wood, *"Project Finance"* (2007), 59-60.

[601] Balala, *"Theory and Practice"* (2011), 138.

unsubordinated creditors of the issuer in the case of insolvency and thus take priority over shareholders – who through their purchase of equities have agreed to be paid after the senior creditor.[602] Islamic law forbids the conventional bond structure in that it is essentially a loan and thus transgresses the *ribā* prohibition. To be sharia-compatible AAOIFI requires that an Islamic securitisation has to result in the undivided ownership by a security holder of shares in "tangible assets, usufruct and services or in the ownership of assets of particular projects or special investment activity".[603] Nevertheless sharia scholars endeavoured to retain the fixed income characteristics of a bond instrument as well as the bond-like priority of security holders over shareholders in the case of default, while giving the structure equity-like ownership features that would render it sharia-compatible. Moreover, attaching equity-like properties to the *sukuk* structure enables it, from a sharia perspective, to be transferable whereas the sale of debt (*dayn*) – as examined in chapter three – is *ḥarām* amongst a majority of contemporary jurists.[604]

Exceptionally, in Malaysia the *bay' al-dayn* has been rendered acceptable by the Sharia Advisory Council of the Malaysian Securities Commission with the proviso that a transparent regulatory environment enables the structure to meet the *maṣlaḥah* objectives of the Malaysian

---

[602] Wood, "*Subordinated Debt"* (1995), 37.

[603] AAOIFI, *Shari'a Standards* (2004-2005), 300.

[604] See Haneef, "Trends" (2005), 29. Soldiers reportedly sold their *sukuk* for cash prior to maturity, despite the *madhhab*s' prohibition of trading in debt (*dayn*). The concept of the *ṣakk* was transmitted to the Latin world of trade by Jewish merchants and became known as a cheque. According to scholars of classical commerce, the *ṣakk* was used interchangeably with the term *saftajah* to denote a financial obligation arising from trade, lending (*qurud*) and partnership (*muḍārabah*) activities. Increasingly, the *ṣakk* became associated with a payment obligation between long-distance trade parties on the basis of trust. See Adam and Thomas, "*Islamic Bonds"* (2004), 44.

Muslim community.[605] As a result, Malaysia has developed liquid *sukuk* markets in which *murābaḥah*, and *bay' bithaman ajil sukuk* certificates are negotiable.[606] However, Malaysian scholars' permissive attitude toward the *bay' al-dayn* is not widely accepted amongst Middle Eastern investors.[607]

Therefore, outside of Malaysia *sukuk* generally cannot be structured on receivables as these represent obligations and may only be transferred at or below par value to avoid the prohibitions of *ribā* and *gharar*. This effectively prevents debt-based Islamic financing structures such as the *murābaḥah* from being securitised. Therefore, conventional receivables such as those related to home mortgage loans, commercial property mortgages as well as consumer receivables including car, boat and truck loans, credit card receivables and various types of equipment leases cannot be used as the underlying assets of *sukuk*. Instead, an issuer of *sukuk* generally seeks to securitise non-debt based immovable assets such as office buildings and land. Oil and gas properties as well as stands of timber are also possible.[608]

Jurists have permitted some blended forms that include a combination of *mushārakah, ijārah* and *murābaḥah* transactions subject to the proviso that the majority of assets should include at

---

[605] Securities Commission Malaysia, "Resolution: Bai' Dayn" (2011).

[606] Thomas, "Malaysia's Importance" (2007). In the fourth quarter of 2007 *murābaḥah sukuk* issuance constituted 11.8% and *bay' bithaman ajil* constituted 4.63%.

[607] Rosly and Sanusi, "Bai' Al-'Inah" (1999), 2.

[608] Wood, *"Title Finance"* (1995), 44.

least 51 per cent tangible assets (*'ayn*).[609] This is substantiated on the basis of the juristic maxim whereby the majority determines the genus and characterisation of the total.[610] The practice facilitates the negotiability of *sukuk,* which is essential to their attractiveness. Not only does negotiability enable a liquid secondary market to take root, it allows these instruments to be rated by recognised rating agencies, listed on major securities exchanges and processed through major clearinghouses.[611]

5.3.2.1 SUKUK AL-IJĀRAH

The *sukuk al-ijārah* (lease-based *sukuk*) is the most popular form of *sukuk* in today's capital markets, although AAOIFI lists fourteen other forms of permissible *sukuk* modelled on the nominate contract scheme. For example, *sukuk* proceeds are routinely invested in *muḍārabah* partnerships, *istiṣnā'* (hire or construction) projects as well as equity participations in the form of *mushārakah* – which represents a co-ownership interest in assets.[612] The *sukuk al-ijārah* has been constructed to mirror the ownership attributes – in this case the ownership of an asset's usufruct (*manfa'ah*) – which Islamic financial principles require. Note holders are construed as

---

[609] Mahmoud El-Gamal, *"Islamic Finance"* (2006), 106. In July 2003 the Islamic Development Bank undertook the first *sukuk* issuance that included a range of assets housed in *ijārah, murābaḥah* and *istisna'* contracts. Known as the *sukuk al-istithmar*, it comprised a $400 million issuance. See Engku, "Issues" (2008), 489.

[610] El-Gamal, *"Islamic Finance"* (2006), 127.

[611] Haneef, "Trends" (2005), , 33.

[612] De Belder, "Securitisation Structures" (2010); Bi, "Sukuk" (2010).

co-owners of a tangible asset similar to the *shirkah* (partnership). The subsequent examination pertains to *sukuk al-ijārah*, although the central issues concern all forms of *sukuk* issuance.

Each co-owner of an *ijārah sukuk* certificate may sell the rights to his asset without the consent of other co-owners at market price, thus enabling the emergence of a secondary market. In 1988 the *Fiqh* Academy of the Organisation of the Islamic Conference (OIC) agreed that a lessee would be entitled to sell his usufruct to a third party (sub-lessee) or the lessor at any mutually agreed rate. Alternatively, the lessor may sell his/her property as long as the sale does not prejudice the lessee's rights. The sharia generally provides that the lessee's ability to sub-lease the asset requires the lessor's permission insofar as third parties may wish to use the property in a different manner or for different purposes. In general, however, the concepts of subleasing and its use in securitisations are familiar to classical jurisprudence so that they may be employed lawfully in a multitude of ways.[613]

The schematic of the *sukuk al-ijārah* proceeds as follows. The originator generally sells a non-moveable asset or assets such as an office building or land to a special purpose vehicle (SPV). The SPV obtains the financing for the purchase by issuing certificates evidencing a note holder's pro-rata beneficial interest in the underlying assets. The SPV purchaser then leases back the asset to the originator for payments equalling the principal and profit margin of the leased asset(s). The SPV distributes variable rental dividends to *sukuk* holders from the lease

---

[613] El-Gamal, *"Islamic Finance"* (2006), 100.

of the asset which are directly tied to the London Interbank Offered Rate (LIBOR), usually plus a 0.40 per cent per annum margin.[614] Upon maturity of the lease, which is timed to correspond with the redemption date of the *sukuk*, the SPV or trustee sells the asset to the lessee for a price equal to the cost of its original acquisition. The SPV is then able to redeem the *sukuk* and *sukuk* holders receive their principal investments. The payment profile is thus comparable to a conventional bond. Moreover, the lessee's (originator) obligation to pay the lease rentals and the final principal payment are ranked as senior unsubordinated debt – a ranking in priority comparable to the ranking of a conventional bond.[615] Like conventional securitisations *sukuk* can be structured to enhance the credit of the offering and thus appeal to a diverse class of investors. Hence, *sukuk* notes can have different ratings and varied exposure to prepayment or default. Those with the highest rating are called senior bonds and those with more exposure are termed subordinate bonds.[616] A *sukuk* issuer takes particular care to choose a jurisdiction in which regulatory and financial service expertise are most advantageous to the overall agreement. Often traditional offshore jurisdictions such as the Cayman Islands and Luxembourg are used for their tax beneficial purposes.[617]

Under the *sukuk al-ijārah* liabilities arising from the regular use of the asset are to be carried by the lessee, while those associated with ownership such as insurance, maintenance and taxation

---

[614] Ibid., 110.

[615] Haneef, "Trends" (2005), 34.

[616] Prasad, "Securitisation" (2006), 5.

[617] De Belder, "Securitisation Structures" (2010).

should be borne by the owners (*sukuk* holders).[618] In practice, the circumscribed role of the SPV, including the need to maintain its bankruptcy remoteness from the originator, results in the creation of agency agreements between the SPV (lessor) and the lessee (originator). The originator, acting as the issuer's agent, agrees to perform any major maintenance and will be compensated by the issuer upon maturity of the *sukuk*.[619] When the originator is not in possession of sufficient funds, the purchase price of leased asset(s) at maturity is amended to comprise the maintenance expenses.[620]

The principal legal issue affecting the commercial viability of *sukuk* securitisations concerns whether a 'true sale' has occurred. While *sukuk* issuers (SPV) strive to provide sufficient documentation that the actual transfer of ownership has taken place (true sale), in practice the originator has transferred beneficial title rather than the actual legal title. AAOIFI states that "ownership is possible under a sale contract, even if the title is not registered in the purchaser's name, on condition that the purchaser should obtain a counter-deed or bill of sale to establish the actual transfer of his ownership of the asset".[621] In cases in which the beneficial transfer relates to immovable properties such as land parcels and buildings, the accepted practice allows the seller (originator) to remain the registered proprietor of the assets as long as a trust

---

[618] Wilson, "Sukuk Market" (2004), 7.

[619] For example, this is how Dubai World's Nakheel *sukuk* was structured. See Nakheel Development Limited, "Offering Circular" (2006), 10.

[620] Wedderburn-Day, "Sukuk" (2010), 328.

[621] AAOIFI, *Shari'a Standards* (2004-2005),140.

declaration – in the case that a trust SPV is used – has been given to the effect that the SPV shall hold the assets as trustee for the buyer.

The use of the securitisation trust represents an agreement in which one person transfers title to specific property to a trustee who is given effective legal control over the asset for the benefit of third person(s) known as *cestuis que trust,*[622] and then for the originator. The trustee issues pro rata investment certificates to investors who are given beneficial ownership of the asset(s). The relationship between trustee and beneficiary is governed by a trust deed or declaration of trust often executed unilaterally by the settlor.[623] It is claimed that the characteristics of the trust fully comply with the sharia and that the concept might even derive from Islamic law.[624] Yet the concept of beneficial ownership, in fact, may be difficult to reconcile with the sharia concept of ownership.

---

[622] Pettit, "*Equity"* (1993), 23.

[623] Balala, *"Theory and Practice"* (2011), 147.

[624] For example, the concept of trust may have originated with the ancient Islamic concept of *waqf.* It permitted an owner to "settle his property to the use of beneficiaries in perpetuity". Cattan, "Waqf" (1955), 203. In addition to the *waqf* several other Islamic legal institutions evince striking similarities with the common law. For example, the common law and the sharia hold that ownership in the property of goods passes upon the conclusion of the contract prior to physical delivery. Although prevalent in the Muslim world, this concept was likely not known to Western legal systems in the twelfth century. The institution distinguishes common law from the Roman legal tradition, which influenced civil law legal traditions throughout the European continent. See Makdisi, "Origins" (1998-99), 1639-51. In general, the common law and Islamic law possess similarities. For more on the inter-relationship of these legal systems in Malaysia, see Horowitz, "Legal Change, Part I" (1994). Horowitz, "Legal Change, Part II" (1994).

By assigning the property to a trustee who holds the assets in trust for the beneficial owners (*sukuk* holders), the lessor or seller maintains legal title.[625] A *sukuk* participation certificate conveys beneficial ownership of a certain share to an investor. An SPV operating agreement or trust indenture define the attributes of ownership including the rights and obligations of each party.[626] The reason for not transferring the registered title to an issuer is a result of unfavourable transfer taxes or similar cost disadvantages that attach to certain jurisdictions.[627]

Some countries, particularly civil law jurisdictions, require parties to utilise the common law concept of trust for a securitisation SPV.[628] However, the use of the trust in common law jurisdictions such as England and the United States is less favoured, probably because:[629]

> (1) The corporate form dodges cumbersome legal issues, such as the liability of the trustee and beneficiaries for obligations incurred by the trustee for the account of the trust and such as the non-recognition of the trust elsewhere.
>
> (2) Flexible security interests and trusts of the SPV's shares are available.
>
> (3) The corporate form is less likely to invite the complexities of regulatory codes controlling collective investment schemes.

---

[625] Balala, *"Theory and Practice"* (2011), 147.

[626] *Adam and Thomas, "Islamic Bonds"* (2004), *72.*

[627] Ibid., 74.

[628] Wood, "*Subordinated Debt"* (1995), 122.

[629] Ibid.

While *sukuk* often utilise the trust SPV most *ijārah sukuk* issuances attribute the risk of underlying assets to the lessee of the asset (originator) rather than the lessor (SPV) for the reason that the lessee has been legally bound to purchase the asset at an agreed exercise price upon a dissolution event.[630] The repurchase agreement provides a guarantee either through issuer or manager covenants that *sukuk* certificates will be redeemed at face value, rather than market value.[631] This essentially indemnifies investors from the adverse performance of the underlying assets. It also enables the originator to mop up any surplus profit from the securitisation for a nominal price upon maturity of the *sukuk*, thus acquiring them for a fraction of their market value. In effect, the purchase undertaking transforms the asset-backed securitisation into a debt owed to note holders. The guaranteed income that this provides is viewed as unjustified enrichment (*ribā*) that fails to expose investors to commercial risk.[632]

Unlike conventional asset-backed securitisations, investors do not have recourse to the underlying assets in the event of default. Default accelerates the purchase undertaking – a promise to purchase the assets upon maturity of the *sukuk* for a nominal value – which, if unfulfilled, would trigger an investor's claim against the originator to be decided in a commercial

---

[630] El-Gamal, *"Islamic Finance"* (2006), 109-10.

[631] Agha and Grainger, "Sukuk" (2010).

[632] Jobst, "Securitization" (2007), 20.

court.[633] The originator's contractual obligations, whether guaranteed or not, clearly indicate that the originator's credit risk is of issue rather than the underlying assets.[634]

Major ratings agencies such as Fitch Ratings and Moody's Investor Service agree that, unlike a true securitisation, the commercial terms and legal structures of *sukuk* issuances show that *sukuk* performance is not governed by the underlying assets. A default event does not allow investors any recourse to the underlying assets.[635] Further, the originator's credit risk should be viewed as the main determinant in that the risks associated with the asset reside with it. Default would accelerate the purchase agreement, which, if unfulfilled, would result in investors pursuing their claim in a commercial court against the originator. This claim would be immediately due and payable whereby the assets underlying the *sukuk* would be available to all senior unsecured creditors (note holders) of the originator.[636]

Moody's perspective of *sukuk* issuances – notably, rating agencies take a substance over form approach to the issue – divides them into two classes: (1) asset-backed *sukuk*, for which ratings are given based on the underlying assets of the *sukuk;* here the risks have been transferred to note holders*;* and (2) unsecured *sukuk,* for which ratings are given based on the originator's or borrower's credit risk. All *sukuk* have underlying assets in the structure but Moody's only

---

[633] Dubai World's Nakheel *sukuk* contained a clause in which a purchase undertaking was triggered by a default event. See Nakheel Development Limited, "Offering Circular" (2006),142.

[634] Ratings, "Fitch's Approach" (2007), 2.

[635] Howladar et al., "Ratings" (2006-2007), 27; Ratings, "Fitch's Approach" (2007), 2.

[636] Ratings, "Fitch's Approach" (2007), 2.

considers them to be asset-backed or asset-secured if the central elements of securitisation ensure that *sukuk* holders have beneficial title and realisable security over the assets.[637] To date, very few rated *sukuk* issuances have fulfilled 'true sale' requirements.[638] The result is that *sukuk* issuances have been given significantly lower ratings than conventional asset-backed structures, thus contributing to increased costs for secured financing.[639] Most *sukuk* securitisations have not been rated as major ratings agencies have shown a reluctance to issue credit ratings on local structures.[640] Asset-based *sukuks'* 'long-term rating' does not exceed the 'issuer default rating' (IDR) of the originator, assuming that no substantial preferential creditors – which rank ahead of *sukuk* note holders – are attached to the originator's assets. In normal circumstances, an originator-backed *sukuk* is considered to have average recovery prospects,[641] although the paucity of historical data on defaults impedes rating agencies' ability to estimate recovery rates used in pricing and rating tranched products.[642]

The fundamental test of ownership according to the sharia is based on who must bear the risk of complete loss or destruction of the asset. Yet the investment returns that the majority of *sukuk* securitisations guarantee force us to rethink modern jurists' position with respect to the concepts of ownership, debt and interest in Islamic law. Clearly the prohibition of the exchange

---

[637] Howladar et al., "Ratings" (2006-2007), 27.

[638] In August 2006, Kingdom Instalment Corporation of Dubai is said to have issued the first 'true sale' *sukuk* securitisation.

[639] Howladar et al.,"Ratings" (2006-2007), 27.

[640] Jobst, "Securitization" (2007), 29.

[641] Ratings, "Fitch's Approach" (2007), 2.

[642] Jobst, "Securitization" (2007), 30.

of debt and the maxim that investment returns derive from the risk of ownership remain the norm in the conscience of the majority of Muslims. However, the gradual acceptance of *sukuk* investment certificates indicates that Muslim jurists may make exceptions to these principles when circumstances dictate. The following section looks at the lively polemic waged surrounding this issue.

5.4 THE STRUGGLE FOR AUTHENTICITY

In chapter four the debate concerning the validity of the binding promise was analysed; its compatibility with the sharia is also at issue with respect to *sukuk* master agreements. However, the most controversial feature of the *sukuk* securitisation structure is the unilateral purchase undertaking given by the originator to the SPV. In February 2008 the sharia board of AAOIFI, headed by Justice Taqi Usmani, struck out at the current practice of issuing *sukuk*, which shocked the market and slowed issuance.[643]

AAOIFI reaffirmed the following sharia issues concerning the issuance of *sukuk*. First, negotiable *sukuk* must be owned by *sukuk* holders, with all the rights and obligations attached to ownership in real assets.[644] This provision concerns the practice of including a re-purchase agreement in *sukuk* master agreements and thus not fulfilling true sale criteria.

---

[643] AAOIFI, "Sukuk Standard" (2008). See Sheikh Usmani's statement on current *sukuk* practices: Usmani, " Applications" (2008).

[644] AAOIFI, "Sukuk Standard" (2008), 1.

Second, negotiable *sukuk* must not be based on receivables or debts, except in exceptional circumstances, when these were unintentionally included.[645] This provision does not mention blended or mixed *sukuk* issuances but presumably these types of issuances were not intended under the provision.

Third, *sukuk* managers, whether acting as *muḍārib* or *sharik* (partner), or as an agent (*wakīl*) are not permitted to offer loans to note holders, when earnings on the underlying assets fall short of expectations. Instead a reserve account may be established for the purpose of covering such shortfalls.[646]

Fourth, *muḍārib*s, *shari*ks or *wakīl*s may not undertake to repurchase the assets from *sukuk* holders, upon maturity or dissolution of the *sukuk*, for a nominal value or their original principal investment. It is permissible, however, to undertake to purchase the assets at their net value, market value or agreed price at the time of actual purchase, i.e. when the *sukuk* has matured.[647] Clearly, the board sought to assuage critics concerning the prevalent practice of *sukuk* issuance, which emulated an interest-bearing debt instrument by assuring investors of their principal investments and shielding them from any losses in proportion to their investment certificates. However, this latter provision does not apply to *sukuk al-ijārah*, whereby a lessee

---

[645] Ibid., 2.

[646] Ibid.

[647] Ibid., 3.

may purchase the leased assets for a nominal value upon extinguishment of the *sukuk*, so long as the lessee is not a *muḍārib* or investment agent.[648]

However, prohibiting this contractual step would remove a key commercial advantage of investment *sukuk* securitisations – namely the originator will no longer be able to profit from the re-purchase of the asset at a nominal value.[649] Further, assets are subject to price volatility and market movements which could significantly alter the original value of the asset over the course of time so that an originator may have to pay more for the asset than it received for the original sale. Nevertheless, this particular feature obviates much of the market risk that *sukuk* holders must countenance and thus leads to unjustified returns.

Finally, sharia supervisory boards should assume greater responsibility for the post-contractual monitoring of "relevant contracts and documents related to the actual transaction" after the issuance of a fatwa to certify sharia-compliance at every stage of the transaction.[650] This final statement criticised current sharia board practices that have enabled *ribāwi* practices to define the industry.

These pronouncements have shocked market investors the world over. One scholar commented that 80 per cent of current *sukuk* structures are not Islamic according to these

---

[648] Ibid., 3-4.

[649] Lessees (originators) may purchase the leased asset for a nominal value in the *sukuk al-ijārah* structure.

[650] AAOIFI, "Shari'a Standards" (2004-2005).

conditions.[651] Sheikh Usmani's re-consideration of the matter is thought to be based on his unwillingness to continue to condone a practice that was conceived to act as a stop-gap measure until the industry had attained a more secure institutional basis.[652] The widespread prevalence of these practices throughout the industry highlights its convergence with conventional financial markets. Importantly, AAOIFI's statement represents a desire to strike a different course and thus provides signals to Muslim investors that the Islamic financial industry is striving for more "authentic" means of financial intermediation.

The AAOIFI resolution contributed to slowing the issuance of *sukuk* in 2008 and beyond due to investor uncertainty concerning sharia-compliance risk, although increased sovereign *ijārah sukuk* issuance may have mitigated the impact since these structures were not adversely affected by the pronouncement.[653] In particular, the fact that the asset(s) underlying *ijārah sukuk* could continue to be purchased, pursuant to a purchase undertaking, at a nominal price is a decisive factor. Moreover, AAOIFI's standards are not the definitive statement on *sukuk* standards.[654] In 2009 the Islamic Financial Services Board (IFSB) issued capital adequacy standards[655] for *sukuk* structures and in 2010 the Kingdom of Bahrain published the Bahrain

---

[651] Islamic Finance Resource, "Proposals" (2008).

[652] Barzilai, "Financing" (2010).

[653] Wedderburn-Day, "Sukuk" (2010), 332. See also Hijazi, "Issuance" (2009).

[654] Richardson, "Integration" (2011), 23.

[655] IFSB, "Capital Adequacy" (2009).

Financial Exchange Handbook[656], both of which included some, if not all, of the *sukuk* practices outlawed by AAOIFI.

By far the most important factor in reducing the global growth of *sukuk* issuance was the 2008 global financial crisis. By the end of 2007 the global volume of outstanding *sukuk* exceeded $97 billion;[657] a trend that, if it had continued, would have seen *sukuk* issuance exceed $200 billion by 2010.[658] However, in 2008 global *sukuk* issuances decreased by a staggering 54.5 per cent to total $15.1 billion.[659] By the end of June 2009 the total value of outstanding *sukuk* totalled $136 billion, indicating that the market was on the path to recovery.[660] 2010 evidenced a dramatic turn-around in the market with record growth in *sukuk* issuance. At $51.2 billion, it surpassed the previous record in 2007 by 34 per cent.[661]

As remarked, AAOIFI's pronouncement is an attempt to chart a different course for the industry as a whole but it may not be a commercially viable strategy. In the background of AAOIFI's statement polarised opinions concerning the imperatives of innovation are in conflict with calls for transactions that are tied to Islam's historical legacy. The practitioners of the Law of Islamic Finance, i.e. sharia scholars, Islamic bankers, lawyers, and others, are part of a project of

---

[656] Bahrain Financial Exchange, "Insight" (2010).
[657] IOSCO, "Objectives" (2008), 9.
[658] Jobst et al., "Islamic Bond" (2008), 4.
[659] Hijazi, "Issuance" (2009), 2.
[660] IIFM, "Report" (2010).
[661] Globe, "S&P" (2010).

coming to terms with the legacy of Islamic law. In a world fraught with competing interests, overriding necessities, and changed realities, the LIF is forged by determining which Islamic principles are malleable and which are non-negotiable.

CONCLUDING REMARKS

The modern *murābaḥah* is a critical contract for facilitating short-term finance for consumer and business needs. The contract illustrates several contracting methods that are used widely in the formulation of Islamic financial transactions. This includes the conglomeration of nominate contracts, the binding promise and the application of *takhayyur*. These tools and legal stratagems – depending on the particular practice – are pivotal to the industry's gamut of financial structures. Yet they raise sharia-compliance concerns regarding ownership. They highlight the LIF's formalistic attachment to legal form over ethical and religious substance.

Some of the indemnities written into *murābaḥah* transactions may fall foul of UK statutory law. In particular, the Sale of Goods Act 1979 and the Unfair Contract Terms Act 1977 may prevent practitioners from incorporating such indemnities into their contracts, depending, again, on the circumstances of the particular transaction.

The practice of contracting in *tawarruq* evinces many of the same legal tools used in the *murābaḥah*. However, this contract, unlike the *murābaḥah*, is widely recognised as a *ḥila*.

Nevertheless it plays an important role for the industry in that it generates financing for business and consumer needs, and provides a crucial instrument for facilitating inter-bank lending.

The *sukuk* securitisation represents a clear example of the way in which the LIF has appropriated conventional financial structures and endowed these with Islamic characteristics. The *sukuk* is designed to achieve bond-like regular income streams and the return of investors' principal while appropriating the equity-like properties of asset-backed securitisations. Securitisations transform non-marketable illiquid financial assets such as receivables into liquid financial assets with the result that originators generate financing and other economic advantages. However, receivables constitute rights to payment (*dayn*) and are not transferable at a discount. Further, bonds are interest-generating and hence not permissible. *Sukuk* certificates are structured to circumvent these challenges by allowing *sukuk* holders to purchase beneficial ownership rights in tangible underlying assets, usufructs or services. Furthermore, *sukuk* certificates based on tangible assets are negotiable.

Securitisations must satisfy 'true sale' criteria if investors are to have ownership rights over the underlying assets. A 'true sale' transfers title to tangible assets to the SPV issuer where these are made 'bankruptcy remote' from the creditors of the originator. In the event that 'true sale' criteria are not fulfilled the securitisation may be re-characterised as a security interest with disastrous consequences for the transaction. Re-characterisation undoes the economic benefits of a securitisation and exposes note holders to creditors' claims against the originator's assets. In England the risk of re-characterisation by an English court is slight. English case law

has established that title finance transactions will be construed according to legal form rather than economic substance as long as the transaction is not a sham. However, in some Middle Eastern jurisdictions, where *sukuk* issuances often originate and where assets are often located, the risk that a commercial court will re-characterise a *sukuk* remains.

The *sukuk al-ijārah* is the most popular form of *sukuk* issuance. The *sukuk al-ijārah*, not unlike other *sukuk* structures, depends on a purchase undertaking in the master agreement that allows *sukuk* holders to receive their principal investments in full. However, purchase undertakings disqualify most *sukuk* issuances to date from being characterised as 'true sales'. This is confirmed by major rating agencies' assessment that an originator's credit rating determines the creditworthiness of the *sukuk* issuance.

From a sharia perspective the concept of ownership requires owners to bear the risk of total loss or destruction of the underlying tangible assets. When a 'true sale' has not been given effect, *sukuk* holders are shielded from the risks of ownership. This predominant practice calls into question whether sharia scholars have revised their perspective concerning the fundamental attributes of ownership and/or the prohibition of *ribā*.

In 2008 AAOIFI issued a declaration concerning some predominant practices of *sukuk* issuance, which rattled markets and exposed a simmering debate. The episode reflects the challenge in forging a modern law that strikes a balance between financial innovation and

Islamic legal tradition. The following chapter examines the legislative implementation of Islamic financial transactions in the United Kingdom.

PART III: THE CHALLENGES IN IMPLEMENTING THE LAW OF ISLAMIC FINANCE

CHAPTER SIX: THE FACILITATION OF ISLAMIC FINANCE IN THE UNITED KINGDOM

INTRODUCTION

This chapter examines the UK government's objective of consolidating an Islamic financial centre in the City of London. The UK government has facilitated Islamic financial transactions by modifying tax measures and amending the conventional regulatory framework. The chapter investigates the domestic and international objectives of this strategy and its methods of implementation. The legislative and regulatory facilitation of sovereign *sukuk* issuance – which is pivotal to establishing wholesale Islamic markets – provides an important demonstration of the way in which the government's strategy is implemented in practice and what legal and economic challenges arise there from.

The chapter is first concerned with assessing the international dimension of Islamic finance and its transmission to the UK. Second, domestic markets and rationales for Islamic finance are analysed. Third, the debate concerning the incorporation of sharia-inspired structures within English law is highlighted. Fourth, the government's legislative and regulatory approach to Islamic finance is scrutinised. Fifth, the implementation of legislative measures, beginning in 2003, is examined. Sixth, the legislative facilitation of sovereign *sukuk* issuance is given consideration as is its economic relevance. Seventh, the facilitation of commercial *sukuk*

issuance is considered and, finally, the regulatory modifications for *sukuk* instruments are examined.

6.1 THE TRANSMISSION OF ISLAMIC FINANCE TO THE UK

Recall that Islamic financial transactions have been conducted in the UK since the early 1980s without any legal or regulatory accommodation. This fact underscores the government's policy of accommodating Islamic finance in response to the financial transactions that had long since been taking place. This is not unusual. Law often develops in response to commercial and financial developments. Nonetheless, the government's policy to erect a tax and regulatory apparatus for Islamic financial transactions represents an important step in stimulating the growth and development of domestic and wholesale markets.

The government's primary objective in facilitating Islamic finance is to strengthen an Islamic financial centre in the City of London and thus maintain London's status as Europe's premier financial centre, and indeed, one of the leading financial centres in the world.[662] The sharp rise in oil prices since 2003 has resulted in enormous liquidity surpluses, primarily in GCC states. Yet the capacity of the region's financial markets has not been able to keep pace with the growth in liquid funds.[663] London's pre-eminent role as a leading financial centre, its strategic position in a global financial network, and its historical ties to Middle Eastern states have

---

[662] London, "Centres" (2010).

[663] Ainley et al., "Islamic Finance" (2007), 7.

enabled it to attract Middle Eastern capital in its bid to consolidate a leading international hub for Islamic finance.

The development of an Islamic financial hub in the City of London highlights the centrality of place against a policy-oriented and academic debate largely concerned with the neutralisation of the nation-state by global communications, the hyper-mobility of capital, and the practices of transnational corporations.[664] The sovereignty of nation-states is being eroded by the liberalisation of world trade and global capital flows. Economic and financial globalisation has enabled the extension of the economy beyond the borders of the nation-state as recent financial crises make clear. A number of leading economic sectors, especially international finance, are now swayed by investor sentiment across the globe. Moreover, global financial markets operate within an increasingly global regulatory framework that is primarily attuned to the demands of the market, to the requirements of transnational corporations and financial institutions rather than the bureaucracy of the state.[665] The world system is increasingly characterised by a highly interdependent and ambivalent relationship between the nation-state and transnational capital.[666]

---

[664] See Sassen, "*Globalization"* (1998), XXI. See also Santos, "*Legal Common Sense"* (2002), 279. Eatwell and Taylor, "*Global Finance"* (2000), 96. Isard, "*Globalization"* (2005), 65.

[665] Cotterrell, "*Law's Community" (1995),* 303; Santos, *"Legal Common Sense"* (2002), 194.

[666] Nadkarni, "World Trade" (1999), 134. Nadkarni argues that national autonomy is being sacrificed to the liberalisation of world trade. Global structures should be erected to channel the destabilising process.

Yet the UK government's facilitation of Islamic finance underscores the pre-eminent role of the nation-state in creating a legal and regulatory framework which enables a particular mode of finance to thrive. It strengthens the premise that global processes materialise in national territories, through national institutional arrangements via legislation and the judicial process. The UK experience with Islamic finance underscores the importance of the state in actively erecting fiscal and legal frameworks through which the global economy works and without whose instruments it simply could not function.[667]

Theoretically, the complexity of this relationship would tend to result in legal heterogeneity in state regulation, embodying diverse political and ideological assumptions as well as different types of law for different areas of state intervention. The emergence of multiple legal orders, constituting "relatively unrelated and highly discrepant logics"[668] within a single state apparatus would unravel the coherence and uniformity of the state-based regulatory framework. Multiple microcosms within a single state, regulated by disparate regulatory logics and styles, would be the likely result.[669] However, the UK's response to the emergence of Islamic finance undermines – to an extent – this theoretical conclusion. The UK has opted to assimilate Islamic finance into the regulatory system rather than create a dual regulatory system that would provide a more favourable and efficient regulatory structure for the industry; but which would

---

[667] Comaroff and Comaroff, "Millenium Capitalism" (2001), 38; O'Brien and Williams, "*Economy"* (2010), 426.

[668] Santos, "*LegalCommon Sense"* (2002), 281

[669] Ibid.

undermine the coherence of the regulatory architecture. Therefore, the state has subjected this transnational phenomenon to national forces.[670]

6.1.1 RETAIL MARKETS

The second objective of the government concerns the inclusion of a large domestic Muslim minority in the financial marketplace, which represents the government's principle of equality of access to financial markets. While discrimination on the grounds of religion or conscience has been unlawful since 2003,[671] the rationale in facilitating Islamic finance is not a political or legal response to incidences of unlawful discrimination. Rather, it is a pro-active, top-down and highly centralised series of measures rooted in a growing awareness that British Muslims have not been able to avail themselves of financial activities due to their Islamic beliefs. Hence, it sends a strong signal to the Muslim community that the government understands their religious needs and seeks to create an environment in which Muslims are able to practice their faith in conformity with their beliefs.

Despite the Islamic finance industry's international growth, UK domestic demand for Islamic financial products and services may be limited. Socio-economic data reveal that Muslims are less economically active than the general population. Of a total of two million British Muslims,

---

[670] Fazio, "*Harmonization"* (2007), 10.

[671] C.f. Hill and Sandberg, "Sacred" (2007); The Employment Equality (Religion or Belief) Regulations 2003, SI 2003/1660.

1.4 million are 16 years of age and older. This age group does not actively engage in financial activities. While eight out of ten of most minority groups in the United Kingdom have accounts with financial institutions – compared with nine out of ten persons of the majority population - only two-thirds of those of Pakistani origin and just over half of those of Bangladeshi origin do. Research has attributed these statistics to Muslims' beliefs in abstaining from interest-based financial transactions, even though British Muslim respondents often argue that interest-based activities are permissible with respect to loans and non-essential consumption.[672] Recall that some modern Muslim thinkers argued that the prohibition of *ribā* applied solely to the essential commodities of daily life whereas loans with interest for purposes of production and wealth creation should escape the prohibition.[673]

Research suggests that this group may be divided into three market segments: First, those for whom Islamic financial products are the only option of which they would avail themselves. Only four per cent are considered under this "staunch demand" category. The second category comprises those who might choose sharia-compliant products, if they were widely available and competitive. This group is believed to constitute a further twenty-one per cent of the population. Finally, those who will continue to use conventional products irrespective of whether Islamic products are widely available constitute seventy-five per cent of the British Muslim population.[674]

---

[672] Meadows, "Access" (2000), 17. Other, less often cited reasons for doing so relate to the classical differentiation between *dar al-harb* (abode of war) and *dar al-Islam* (abode of peace). Some classical jurists argued that interest could be accepted from infidels in the *dar al-harb*, i.e. non-Muslim territories.
[673] See, for example, Rahman, "Ribā " (1964) in s 4.3.
[674] NS&I, "Review" (2008), 3.

Therefore, the short-term demand for retail sharia-compatible products looks to be relatively low, and indeed, their acquisition has thus far been limited.[675]

However, government consultations with industry practitioners and consultants on the development of Islamic financial products suggests that very significant medium to long term demand for such products exists in the domestic market,[676] particularly if the UK were to issue a sovereign *sukuk* (Islamic bond) and thus help to establish a secondary market and other key economic benchmarks which would facilitate the industry. In particular, a *sukuk* issuance would help generate a wider range of retail financial products which thus far have remained quite limited.[677] In the short term the "exchequer effect" – the inflow of tax revenues to the treasury – is negligible, while the government sees long term inflows as potentially significant[678] as a result of the greater diversity and quality of Islamic products. In sum, the government foresees a thriving and competitive Islamic financial industry – both retail and wholesale – as benefitting London as a leading financial centre and generating "further investment, jobs and tax revenues in the UK economy".[679]

---

[675] MCB, "Consultation" (2008), 5.; Amin, "Retail" (2010).

[676] HMRC, "Assessment: Sukuk" (2008), 5.

[677] MCB, "Consultation" (2008), 5.

[678] HMRC , "Assessment:Sukuk" (2008), 5.

[679] Ibid.

Financial accommodation may help to incorporate unregulated Islamic financial activities whose market participants are otherwise deprived of regulatory and consumer protections[680] and whose financial activities undermine the state's fiscal and monetary policies. Some minority groups have traditionally sought financial advice, borrowing and lending within the community on the basis of recommendations and kinship networks. In effect, informal credit unions have been established in many areas housing large minority communities.[681] For example, research concerning *ḥawālah*[682] money transfer systems highlights a complex web of global traders whose ability to transfer money to the far reaches of the globe undercuts the nation-state's ability to keep tabs on its citizens' monetary activities.[683] *Ḥawālah* (transfer in Arabic), refers to informal swap arrangements that facilitate financial transfers that leave no audit trails for subsequent regulatory scrutiny. Operated from unlicensed and unregistered storefronts in Western Europe and North America, workers use *ḥawālah* to transfer remittances to all manner of locations throughout Asia and the Middle East.[684] Such informal Islamic commercial transactions reflect the limits of state law as these are weakened by the allegiance of subjects to competing legal norms.[685] In co-opting informal Islamic financial practices Muslim minorities may feel that they should and can conform their behaviour to the requirements of state law. The government stands a greater likelihood of compelling compliance amongst minority Muslim

---

[680] HMRC, "Assessment:Stamp Duty" (2009), 5.

[681] Meadows, "Access" (2000), 17.

[682] For an account of the classical sharia concerning *ḥawālah* see Ray, "Medieval" (2007).

[683] See Ballard, "Reciprocity" (2005), 321.

[684] Ibid., 320-21.

[685] Allot, "*Limits"* (1980), 148; Menski, "*Comparative Law"* (2006).

populations by bringing previously informal transactions under legal auspices into the regulatory light.

6.1.2 THE INCLUSION OF THE SHARIA IN ENGLISH LAW

There may be some public antipathy to the adoption of Islamic financial structures within the UK legal system. In a public response to a government consultation regarding the issuance of *sukuk* in June 2008 a number of respondents "believed that it was inappropriate for the government to issue *sukuk* or to take any action which could result in the incorporation of the sharia law into English law". [686] This may arise, in part, due to uncertainties surrounding the issue of sharia compliance. Respondents suggested that disclaimers may be required so as to shield the government from claims that it engaged in marketing non-sharia-compliant products. Respondents rightfully observed that the government's facilitation of Islamic financial structures within English law forced it to adopt "valid" interpretations of sharia-compatible structures. The government concedes that "it has not yet decided its preferred way to ensure the sharia compliance of *sukuk* issuance",[687] which indicates that the legal ramifications resulting from its policies towards the industry are not yet known.

More generally, the facilitation of the sharia within English law adds oil to the fire of a raging debate in Europe concerning the public role of Islam and the compatibility of Islamic principles

---

[686] Treasury, "Sukuk Issuance: Response" (2008), 39.

[687] Ibid.

and values within a largely secular social environment. In February 2008 the Archbishop of Canterbury, Dr. Rowan Williams, delivered a speech in which he addressed the existence of minority communities within the United Kingdom which subscribe to normative systems other than the English legal system alone.[688] Dr Williams examined whether space could be allowed alongside the secular law of the state for the legal norms and rules of faith groups. The most frequently raised objection to the recognition of supplementary jurisdiction in particular areas of the law, especially family law, concerns whether it may have the effect of reinforcing retrograde or regressive practices within ethnic minority communities. In particular, the treatment of women is a particular concern. Dr Williams acknowledged this concern by laying out a general framework of how faith-based legal practices could be accommodated. He stated that were "any kind of plural jurisdiction ... recognised, it would presumably have to be under the rubric that no 'supplementary' jurisdiction could have the power to deny access to the rights granted to other citizens [regardless of faith affiliation], or to punish its members for claiming those rights".[689] He stressed the importance of working to overcome the ultimatum that ethnic minorities have to choose between their culture or their rights.[690] The role and rule of law in a pluralistic society must be reconsidered. A society that is ethnically, culturally and religiously diverse and in which identity is formed within different "contexts of belonging" must not be subject to a "universal/abstract dimension of social existence".[691] Instead the role and rule of law should be premised upon establishing a space for "everyone in which it is possible to affirm and

---

[688] See Williams, "Lecture" (2008), 262.

[689] Ibid., 268.

[690] Ibid., 270.

[691] Ibid., 271

defend a commitment to human dignity".[692] It may be possible to accommodate "certain carefully specified matters" such as Islamic finance or aspects of law that achieves this objective.[693]

The Archbishop presciently stressed that manifold anxieties had arisen in the context of the discussion; an analysis that was confirmed in the vociferous response to the Archbishop's erudite presentation. The Archbishop noted that social anxiety had arisen, in part, as a result of sensational reporting on particular Muslim communities who wish to live according to the sharia. He highlighted the fact that most people perceive the sharia as repressive towards women and archaic and brutal in its physical punishments for crimes that no longer exist in the modern world.[694] The Muslim scholar, Tariq Ramadan, voiced the unspoken when he wrote: "In the West the idea of sharia calls up all the darkest images of Islam […] It has reached the extent that many Muslim intellectuals do not dare even to refer to the concept for fear of frightening people or arousing suspicion of all their work by the mere mention of the word".[695] Moreover, the sharia's fourteen hundred year history has been besmirched by global jihadists who invoke Islamic texts as a justification for terrorist attacks around the world, most notably in the attacks of 11 September 2001 and the London underground and bus attacks of 7 July 2005. Sectarian killings in the wars of Iraq and Afghanistan have repeated this trend and strengthened the perception that Islam is hostile to the democratic values of the West. A general wariness toward Islam pervades the Western social consciousness, and increasingly morphs into outright

---

[692] Ibid., 272.

[693] Ibid, 274.

[694] Ibid, 263.

[695] Ramadan, "W*estern Muslims"* (2004), 31. C.f. Williams, "Lecture", 263.

Islamophobic denunciations.[696] It is therefore plain that the ongoing debate concerning the multicultural society in the United Kingdom is also a debate about the role of Islam in public life.

Arguably, the world of finance has generally been viewed as a less delicate terrain in which to address issues of multicultural accommodation; indeed, commercial law is seen as less impermeable to outside influences and transplants. The national ethos of commercial law is less determinant with respect to a country's legal culture.[697] This characteristic of commercial law is evident in its emphasis on the importance of the economic substance of transactions – the so-called "real" activity that can be "objectively" observed, whereas other areas of law are normatively conceived with respect to a society's values and culture. Culture apparently plays only a small role in this "extra-cultural" analysis.[698] Globalisation assumes that commercial activity, in particular, converges toward cultural homogeneity and thus culture is regarded as superfluous. However, business and financial activities are, to an extent, just as much a reflection of local and national culture as any other area of human endeavour.[699]

---

[696] The examples are numerous. Consider legislation across Europe to forbid the wearing of the *niqab* or head covering that conceals the face. France is the most prominent example. See Loi No. 2010-1192 du 11 Octobre 2010 interdisant la dissimulation du visage dans l'espace public(1). In the United States the Qur'an has been publicly burned and the building of mosques unduly criticised, and so forth.

[697] Santos, "*Sense"* (1995), 213.

[698] Leff, "Economic Analysis" (1974), 464. For a slightly different analysis see examples of the economic analysis of the law. Posner and Parisi, "Wealth" (1985); Eric A. Posner, "*Law"* (2001); Richard A. Posner, "Law and Economics" (1997).

[699] Foster, "Comparative Commercial Law" (2007), *in passim*.

The larger objective of furthering the development of an Islamic financial hub could be very profitable. The commercial benefits of continuing to lure Middle Eastern capital to the UK are potentially very significant and the social advantages of creating an inclusive financial system are many.[700] Even better, relatively few legislative amendments are necessary for facilitating the industry and these are neither overly burdensome nor expensive.[701] A series of regulatory impact statements regarding proposed tax amendments to facilitate the issuance of commercial *sukuk* reveal that the associated costs are negligible.[702] Furthermore, despite the Great Recession of 2008 and the Eurozone crisis, finance remains a rather technical specialisation whose complexities are not easily understood and do not command the attention of the general populace.[703] In particular, the general public is still largely unaware of the government's role in facilitating Islamic finance in the UK.[704]

The cultural and values-dominated debate concerning the inclusion of sharia in English law has not featured prominently in the facilitation of Islamic finance.

The following section is concerned with the legislative and regulatory approach that the UK government has taken toward Islamic finance.

---

[700] Islamic financing was central to the Clifford Chance-assisted £1.25 billion acquisition and funding of the Chelsea Barracks site. It also plays a role in the construction of commercial real estate projects such as the Shard – at 280 metres the tallest building in the UK. Furthermore, real estate buyers from the Arab world continue to invest in London properties – particularly after the Arab Spring (2011) – and Islamic finance is considered a suitable vehicle for doing so. See Hammond, "Horizon" (2011).

[701] HMRC , "Assessment: Stamp Duty" (2009), 2.

[702] HMRC, "Assessment: Sukuk", 2:5.

[703] Lanchester, "Whoops" (2010), xv.

[704] Treasury, "Development" (2008), 21.

6.2 THE LEGISLATIVE AND REGULATORY APPROACH TO ISLAMIC FINANCIAL TRANSACTIONS

The UK government characterises its uniform legislative and regulatory approach to Islamic finance as fair and consistent, rooted in the belief that no financial system deserves special treatment to the detriment of others. It states unequivocally that "all financial institutions authorised by the FSA and operating in the UK, or seeking to do so, are subject to the same standards. This is true regardless of their country of origin, the sectors in which they wish to specialise, or their religious principles".[705] In essence, the government espouses a religiously "neutral" position predicated on the establishment of a "level playing field" for Islamic finance that is not distorted by tax and regulatory law originally conceived for the conventional, interest-based system.[706] As a result, since 2003 all legislative amendments to acts of parliament including both finance and regulatory provisions refer to "alternative financial instruments" when referring to general Islamic financial products and "alternative investment bonds" when referring to Islamic bonds; so that the religiously descriptive "Islamic investments" is replaced with the ideologically neutral "alternative financial instruments". These usages are in line with a universalistic approach to the law which emphasises the equal dignity of citizens and refrains from taking legislative positions on particular religious, cultural or value-embedded norms of minority populations.

---

[705] Ainley et al., "Islamic Finance" (2007), 11.

[706] Treasury, "Development" (2008), 13.

Indeed, the government states unequivocally that “legislation will not be tied to the Quran or the Islamic faith, but rather uses intrinsic features of the underlying contracts under UK law to define transactions to which the rules will apply”.[707] However, as will be made evident, sharia principles and rules have been implemented using English law. So while the state does not take responsibility for the religious interpretation of the transactions it facilitates, legislation necessarily does have a connection to the Quran and Islamic law. Furthermore, the state has facilitated certain Islamic financial contracts which reflect a specific understanding of Islamic commercial law. The state has not taken any direct action in determining the religious meaning of these structures, but it has willingly accepted others’ interpretation of what the sharia constitutes (one of many) in financial dealings. Yet this does not concern the state because its sees its role as a facilitator of these transactions. It is prevented by the terms that underlie its legitimacy and existence from dictating the preferences or wants of its citizens.

The following section examines how this approach guides the legislative implementation of Islamic financial transactions. The treatment of tax issues in this thesis is limited to the most important principles necessary to facilitate Islamic financial transactions. A complete analysis of tax issues will not be pursued in this thesis.

---

[707] Treasury, "Alternative” (2007), 6.

6.3 THE LEGISLATIVE IMPLEMENTATION OF ISLAMIC FINANCIAL TRANSACTIONS

The government highlights several critical barriers to industry development in which it aims to focus its attention: namely, (1) taxation and regulation; (2) standardisation; (3) industry awareness; and (4) the development of industry-related skills.[708] In practice, the government's focus has principally centred on amending tax measures so as to accommodate Islamic financial structures within the UK's complex tax regime. It has enacted very few regulatory measures as such an approach would indicate differential regulatory treatment. Moreover, its efforts toward legal standardisation are relatively minimal insofar as the government does not see its role in determining valid sharia structures. Finally, the government has expended some effort in establishing industry awareness and related training programmes.[709]

In terms of taxation and regulation, the government, quite crucially, has adopted the principle that treatment should follow the economic substance of transactions rather than the legal form.[710] This is particularly important since it enables Islamic financial products to be implemented competitively within the conventional tax regime. If Islamic financial transactions were taxed according to their legal structure in such a regime, they would receive less favourable tax treatment as a result of their multi-tiered architectures. The economic substance

---

[708] Treasury, "Development" (2008), 15.

[709] Secretariat, "Background" (2011).

[710] Treasury, "Development" (2008), 15.

approach results in Islamic financial products being treated on the same basis as equivalent interest-bearing financial products; ordinary tax rules should apply where possible; and rules that foster undesirable or unpredictable results should be amended.[711]

For tax purposes, Islamic financial products are categorised in two types of returns; namely, alternative finance returns and profit share returns. Both types are treated equivalently for corporation tax purposes in that they describe "amounts paid or received" that are, in substance, equivalent to interest.[712]

In light of these objectives the government, in conjunction with industry and through the joint HM Treasury and HM Revenue & Customs Tax Technical Group, initially set out to deal with alternative property financing, known in the industry as Islamic home mortgage purchase plans (HPPs). To this effect, stamp duty land tax (SDLT) was amended for alternative finance arrangements in the Finance Act 2003.[713] Stamp duty land tax is a real estate transfer tax that falls due on real estate purchases at varying rates. After the March 2010 Budget a maximum rate of 5 per cent can be levied.[714] A purchaser of real estate pays SDLT on the entire purchase price of the property. No further payment of SDLT is required with repayment of the loan.[715] Popular nominate contracts used in real estate financing such as the *murābaḥah* and the

---

[711] Ibid.

[712] HMRC, "Stamp Duty" (2008), 22.

[713] Finance Act 2003, ss 72-73.

[714] DirectGov, "Budget" (2011).

[715] Amin, "Policy" (2010).

diminishing *mushārakah* each entail the transfer of property in at least two instances: once when the IFI purchases the asset and again, when the IFI sells the asset to the client buyer. In each transaction SDLT would be payable twice, making such transactions considerably more expensive.

The law was amended so that contracting parties' acquisition of a chargeable interest or property acquisition would not be taxed multiple times.[716] By removing this obstacle Islamic financial institutions were able to offer the *murābaḥah* or the *tawarruq*. These contracts, whose returns equate in economic substance with a loan, would be taxed as if they were loans.[717]

SDLT provisions were extended in 2005 to equity sharing arrangements such as the *muḍārabah*. Alternative finance returns resulting from the transaction were treated as interest payable on a loan.[718] Thus Islamic financial institutions could introduce deposit arrangements based on the *muḍārabah* contract that had previously treated *muḍārabah* profits as dividends.[719]

Recall that the *muḍārabah* is an investment partnership which, if successful, generates a profit from the investment. The Income and Corporations Taxes Act 1988 (ICTA), had long prevented

---

[716] Finance Act 2003, sec 72, 73.

[717] Treasury, "Development" (2008), 16.

[718] Finance Act 2005, pt 2, ch 5.

[719] Treasury, "Development" (2008), 16. However, the *muḍārabah*-like contract IFIs offer on the deposit-taking, liabilities side of their balance sheet differs considerably from the classical principles of the contract.

companies from disguising equity finance in the form of debt so as "to obtain tax relief for payments that are economically equivalent to dividends to risk bearing shareholders.[720] ICTA 1988 s 209 (2)(e)(iii) defines a distribution as:

> (e) any interest or other distribution out of assets of the company in respect of securities of the company (except so much, if any, of any such distribution as represents the principal thereby secured and except so much of any distribution as falls within paragraph (d) above), where the securities are—
> (iii) securities under which the consideration given by the company for the use of the principal secured is to any extent dependent on the results of the company's business or any part of it;

Under section 209 (2)(e)(iii) any profits generated from the transaction would be treated as a distribution and subjected to corporation taxes. The profit share would not be tax deductible by the IFI,[721] which would make these transactions uncompetitive. The government solved this problem by amending Finance Act 2005, section 54, which excluded the *muḍārabah* from 1988 s. 209 (2)(e)(iii):[722]

> Profit share return is not to be treated by virtue of section 209(2)(e)(iii) of ICTA as being a distribution for the purposes of the Corporation Tax Acts.

Therefore, for the purposes of Finance Act 2005, the *muḍārabah* is treated as a loan relationship.[723] Of course, the theoretical *muḍārabah* should not be transacted as a loan relationship as this implies a fixed interest return. Yet if the contract is to be practiced as set out

---

[720] ICTA, s 209 (2)(e)(iii). Amin, "Policy" (2010).

[721] Ibid.

[722] Finance Act 2005.

[723] Deringer, "Alternative" (2008).

in classical texts its profits should be treated as dividends and taxed accordingly. Otherwise, conventional equity investments would not benefit from the same exclusions. The fact is, however, that the industry does not practice the *muḍārabah* in conformity with the sharia, and hence Finance Act 2005 has carved out an alternative loan relationship,[724] that treats its dividends as interest. Chapter eight examines the regulatory rationales for treating it in this manner.

Further relief was carved out for shared ownership products such as the diminishing *mushārakah* (a form of progressively diminishing shared ownership in which the borrower gradually acquires the lender's share in the asset), by giving it SDLT relief. Moreover, the existing *ijārah wa iqtinā'* (lease based mortgage) received relief, effective in Scotland. Finally in 2005, sharia-compliant child trust funds were regulated so that providers could enter the market competitively.[725]

The Finance Act 2006 enabled the introduction of the *wakālah* or profit share agency whereby an investor appoints an agent to manage an invested sum of money and is entitled to a return that is equated, in substance, as interest.[726] Further modifications in 2006 included the introduction of legislation enabling the use of *ijārah wa iqtinā'* in asset finance; HM Revenues & Customs allowed the use of diminishing *mushārakah* as a standard loan; SDLT relief was

---

[724] Finance Act 2005, s 50(2)(b).

[725] HMRC , "Stamp Duty" (2008), 7. Finance Act 2005, ch 5.

[726] Treasury, "Development" (2008), 16; Finance Act 2006, s 95-98.

extended to companies, trusts, charities and partnerships seeking Islamic products (it was previously was only available to individuals); and secondary legislation empowered the FSA to regulate Islamic Home Purchase Plans (HPPs).[727] Alternative property finance relief is only available where the "first transaction" is one in which any of the reliefs under schedule 7, paras 1-13 of the Finance Act 2003 apply, e.g. group, reconstruction and acquisition reliefs. This requirement ensures that only one relief can be claimed in an effort to stem tax avoidance.[728]

6.4 IFIS AND LIQUIDITY RISKS

Section 6.4 is concerned with wholesale money markets. In particular, it examines the way in which sovereign *sukuk* issuance would help to alleviate Islamic finance's liquidity risks.

The London Stock Exchange has emerged as a global centre for the issuance of *sukuk*. By 2010 the exchange had listed 34 *sukuk* issues with a value just under $19.9 billion, more than any other global exchange.[729] However, the government would like to develop the market further inasmuch as it sees the potential benefits of *sukuk* issuance flowing to the City of London and to the wider community. In particular, sovereign *sukuk* issuance would enhance

---

[727] Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2006, SI 2006/2383.
. HMRC, "Stamp Duty" (2008), 7.
[728] Natalie Schoon, "*Islamic Banking"* (2009), 157.
[729] LSE, "Islamic Factsheet" (2010).

the City of London's ability to attract further commercial *sukuk* structuring activity and, more generally, business activity related to the Islamic financial industry.

In addition, the government launched a feasibility study on the issuance of sovereign *sukuk* in April 2007 to examine the benefits and costs of whether the UK government should become an issuer of wholesale sterling Islamic financial instruments, and to consider the legal implications of doing so.[730] It is believed that a UK sovereign *sukuk* issuance could potentially facilitate the development of a greater range of sharia-compliant retail financial products such as Islamic individual savings accounts (ISAs), other savings accounts and capital guaranteed investment products. This has the potential of including those in financial markets who would otherwise refrain from investing in the conventional financial system.[731]

Market participants are concerned about liquidity risks as several sharia prohibitions, such as the prohibition of trading in debts (*bay' al-dayn*), restricts banks' ability to generate liquidity rapidly.[732] Most conventional institutions repackage and sell off their loans and thus retain relatively accessible deposits of liquidity. This process – the negotiability of claims – enables parties to trade loans and other contingent claims. Negotiability is not only the defining characteristic of a capital market, it dramatically enhances the power of financial technology.[733]

---

[730] See Treasury, "Sukuk Issuance: Consultation" (2007).

[731] Ibid., 8. For the general reasons behind sovereign bond issuances, see Fry, "*Government Debt*" (1997).

[732] Abdullah, "Liquidity" (2010), 13.

[733] Goetzmann and Rouwenhorst, "Innovations" (2005), 7.

Islamic law's prohibition of the sale of debts means that this financial innovation is largely outside its reach. The resulting dearth of Islamic financial instruments has prevented Islamic banks from quickly raising funds from money markets.

The underdevelopment of cross-border Islamic inter-bank money markets or Lender of Last Resort (LLR) facilities to which IFIs could turn for short-term loans that do not engage in interest-based financing compounds this problem.[734] The inter-bank market is a wholesale market in which banks lend surplus funds or borrow from each other when their reserves are low. Loans are normally for very short periods (from overnight to fourteen days) although some institutions lend for three, six and one year terms.[735] The current inadequacy of cross-border Islamic liquidity markets negatively affects IFIs' ability to manage their liquidity and risk management requirements.[736] Instead Islamic Interbank lending arrangements generally originate from bespoke financing rather than capital market structures, although some central banks including those of Malaysia, the UAE and Indonesia have established Islamic interbank platforms.[737] For example, in February 2002 the governments of Bahrain, the United Arab Emirates, Saudi Arabia and Kuwait established the Liquidity Management Centre (LMC) in an effort to establish an active and geographically expansive Islamic interbank market. Each

---

[734] Chapra and Khan, "Regulation" (2000), 32.

[735] In London the rate of interest paid on interbank loans is known the London InterBank Offer Rate or LIBOR. LIBOR is an important reference for banks since it indicates the cost of raising immediate surplus funds. See Howells and Bain, "*Financial Markets"* (2007), 129-30.

[736] Abdullah, "Liquidity" (2011),18.

[737] Ibid., 8.

country's twenty-five per cent equity stake is designed to help financial institutions address liquidity mismatches through the issuance of short and medium term liquid investments. [738] Further, the central bank of Malaysia, Bank Negara Malaysia, operates a commodity *murābaḥah* programme based in large part on the *bay' al-'inah* contract. However, the *bay' al-'inah* is repudiated by most schools of law, which highlights the challenge in creating globally accepted and standardised products that have an appreciable effect on markets outside of Malaysia.[739]

These problems have resulted in cumbersome settlement and operational procedures as well and a limited supply of short-term money market instruments.[740] A number of institutions offer overnight *murābaḥah* structures on an accommodation basis, but there is no Islamic institutional arrangement equivalent to the conventional inter-bank market.[741] Another difficulty in creating a sharia-compliant overnight product consists in developing the right risk/yield profile. A number of products have been launched but subsequently withdrawn despite a huge demand for the facility.[742] Thus the potential market for overnight products is large and will likely prove to be a watershed in the development of the industry.

---

[738] LMC, "Vision & Role" (2011).

[739] Dusuki, "Murābaḥah" (2008), 179.

[740] Abdullah, "Liquidity" (2010), 19.

[741] Cox, "Capital Markets" (2007), 274.

[742] Cox, "Capital Markets" (2007), 274.

Moreover, the dependence on bilateral arrangements for the deployment of interbank liquidity has empowered the institutions able to accommodate such instruments. The small cadre of institutions which dominate overnight lending has slowed the development of standardised products and systems that otherwise remain ad hoc and variable across regions. Despite the fact that the Islamic financial industry needs a centralised interbank liquidity programme, the difficulty resides in locating sufficient numbers of founder participants who are willing to invest in and support its development – a task which has not been easy.[743]

As a result, the commodity *murābaḥah* is the preferred structure for interbank lending across most jurisdictions.[744] Known in practitioner circles as the "*murābaḥah* syndrome", the allocation of liquidity has been dominated by the *murābaḥah.* Reviews of audited financial statements reveal that more than 65 per cent – 80 per cent according to many estimates – of banks' balance sheets is allocated to this type of investment.[745] Yet a number of fixed costs associated with transacting in *murābaḥah* make short-term investment in these instruments expensive. UK Market observers argue that a 'bill-like' *sukuk* – a *sukuk* with a shorter maturity – would lower transaction costs so that Islamic banks could address their liquidity and reserve requirements more cost-effectively.[746] Most issuances offer maturities of three, five and ten years and thus do

---

[743] Ibid., 275-76.

[744] Abdullah, "Liquidity" (2010) 19.

[745] Cox, "Capital Markets" (2007), 272.

[746] Treasury, " Sukuk Issuance: Response", 17.

not solve IFIs' requirements for alternative money market-like instruments with considerably shorter maturities.[747]

6.5 SOVEREIGN SUKUK ISSUANCE

In the UK no institutionalised interbank lending arrangements are available for IFIs that do not involve interest. The issuance of short-dated sovereign *sukuk* similar to Treasury bills would help alleviate short-term liquidity pressures.[748] The characteristic mismatch between the long term maturities of originated loans (via partnership or other investment contracts), and short term financing derived from retail bank deposits, which are available on demand, has limited IFIs long-term investments. The result is a situation characterised by either a surplus of cash in need of investment or a shortage of cash to meet liabilities.[749] Long-term investments are generally less liquid, but more profitable; whereas short-term investments are less profitable, but more liquid. Banks have generally shied away from making investments in partnerships, in part, due to short-term liquidity concerns, but primarily due to an aversion to commercial risk in preference for less risky modes of short- and medium-term structures such as *ijārah* and *murābaḥah*.[750] Islamic banks would gain an essential tool in managing their extension of credit.[751]

---

[747] DiVanna and Sreih, "*Islamic Finance" (2009),* 57.

[748] Amin, "Liquidity" (2011).

[749] El-Hawary et al., "Regulating" (2004), 23.

[750] Ibid., 17.

[751] DiVanna and Sreih, "*Islamic Finance"* (2009), 58.

UK sovereign issuance may also encourage other Western sovereign and corporate issuers to access Islamic financial markets due to the framework it would establish. A UK issuance may act as a risk-free benchmark to facilitate the pricing of other issues in the Islamic financial market. Indeed, a liquid benchmark reference may provide a pricing reference for other *sukuk* issuances, and thereby avoid the need for benchmarking against an interest-based product, as is the case with the frequent use of LIBOR. Importantly, it would increase secondary market liquidity in the *sukuk* market[752] with important results for the types of financial instruments Islamic financial institutions must necessarily offer so as to remain commercially viable. Finally, sovereign *sukuk* issuance may provide a catalyst for the development of Islamic pensions and insurance (*takaful*) due to the degree of certainty with respect to a bank's cash flows that issuance may provide.

Moreover, sovereign *sukuk* issuance would assist Islamic financial institutions in meeting their capital reserve requirements by generating liquid structures which are tradable in secondary markets. Thus issuance would also help to strengthen the balance sheet of UK Islamic financial institutions by providing AAA-rated sterling denominated assets for investment, which qualify as a claim on a central government according to Basel II.[753]

---

[752] Treasury, "Sukuk Issuance: Response" (2008), 15.

[753] Ibid.

Basel II leads banks to use instruments with a nil or low regulatory capital, which highly rated liquid investments such as 'bill-like' *sukuk* would offer as opposed to less highly rated (riskier), less liquid *murābaḥah*.[754] Hence, the ability to invest reserve requirements in government *sukuk* would provide IFIs with a much needed liquidity instrument and simultaneously reduce capital costs.

Islamic investors would also benefit from the diversification of investment opportunities that a sovereign *sukuk* issuance affords. The UK government's consultations and legislative implementations are designed to create a legal path toward plain vanilla *sukuk al ijārah*[755] offerings whereas other structures could be introduced over time. Past *sukuk* issuances have been relatively limited in structural diversity. *Murābaḥah sukuk* have generally been issued in Malaysia while GCC states have preferred *mushārakah sukuk*. The expansion of *sukuk* issuance beyond these regional centres would improve the asset risk exposure of investors. Furthermore, the lion's share of *sukuk* issuances are denominated in US dollars or in local currencies, so an issuance in sterling would diversify the existing currency spectrum and provide opportunities for implicit foreign exchange hedges enabling financial institutions to manage exchange rate risk more efficiently.[756]

---

[754] Treasury, "Sukuk Issuance: Response" (2008), 17.

[755] Plain "vanilla" financial products are the most basic and standard versions of financial instruments. They are not exotic or customised to any great extent.

[756] Jobst et al., "Islamic Bond" (2008), 18.

In June 2008 the government issued a report entitled, "Government Sterling *Sukuk* Issuance: A Response to the Consultation" which described several negative factors affecting the decision to issue sovereign *sukuk*.[757] A number of points were made, including concerns whether issuance could be more costly than conventional issuance, either as a result of up-front structuring costs, or because investors could charge a premium to invest in *sukuk*. Demand for AAA-rated sterling denominated *sukuk* issuance is completely untested and may prove to be limited as a result of currency preferences and/or the relatively low yield investors could extract from such investments. Furthermore, the potential for differential pricing between 'bond-like' *sukuk* and gilts is likely due to the lower liquidity in 'bond-like' *sukuk* secondary markets. *Sukuk* holders tend to buy and hold their investment certificate, thus minimising their liquid enhancing quality.[758] And the issuance of bond-like *sukuk* rather than 'bill-like' *sukuk* (with considerably shorter maturities) creates a price risk due to the importance placed on liquidity of longer-dated instruments.[759] The success of a *sukuk* issuance is usually measured by the pricing and distribution achieved. Issuances priced at substantially higher levels than conventional equivalents of similar credit quality are generally unattractive to investors.[760]

Moreover, some respondents argued that 'bond-like' *sukuk* issuance could fragment sovereign debt issuance to the detriment of the gilt market and lead to overall increased costs. Interestingly, a large number of respondents felt that Middle Eastern investors would not be

---

[757] Treasury, "Sukuk Issuance: Response" (2008), 11-20.

[758] DiVanna and Sreih, "*Islamic Finance"* (2008), 58.

[759] Treasury, "Sukuk Issuance: Response" (2008), 20.

[760] Gray and Ismail, "Regulating" (2007), 285.

interested in 'bond-like' *sukuk,* as Islamic banks in the region have relatively high funding costs which may make UK sovereign issuance priced at, or close to, gilts, less attractive. However, existing gilt investors, as well as UK-based Islamic banks and overseas central banks, were thought likely to take an interest in a 'bond-like' issuance.[761] In addition to pricing risks, respondents noted that the sharia risk associated with the structuring of *sukuk* issuance could potentially affect whether *sukuk* issuance is acceptable to a broad range of investors due to the lack of standardisation in the market. Moreover, the emerging standardisation of sharia-compliant products raises questions as to whether a *sukuk* issuance, once deemed sharia-compliant, may subsequently be found to fall outside of the standard,[762] a critical issue that resurfaces across the range of Islamic financial contracts.

Liquidity risks associated with a lack of institutional inter-bank lending arrangements present unique challenges to the industry that sovereign *sukuk* issuance may help to ameliorate. Section 6.5 examines UK legislative and regulatory measures designed to facilitate commercial *sukuk* issuance.

6.6 THE IMPLEMENTATION OF COMMERCIAL SUKUK

In 2007 the government's policy of developing the Islamic financial industry was extended to commercial *sukuk* issuance. The target market for commercial *sukuk* is directed towards high

---

[761] Treasury, "Sukuk Issuance: Response" (2008), 20.

[762] Ibid.

net worth individuals, largely from the Muslim world, and corporate investors. The government felt that some interest could be generated amongst sovereign wealth funds and Western investors as these entities may require relatively secure investments as part of their portfolio management.[763] Furthermore, because Islamic financial institutions are unable to raise finance via traditional securities markets, the ability to issue *sukuk* in the UK would assure them of much-needed wholesale funding. Reports indicate that up to 26.2 per cent of global issuance is undertaken by Islamic financial institutions.[764] Therefore, the Treasury and HMRC set out to establish a transparent tax structure for commercial *sukuk* structures in the 2007 Finance Act which would provide tax certainty for all interested parties.

Before 2007, *sukuk* received a more onerous tax treatment than conventional debt securities. *Sukuk* were taxed according to the underlying legal form of the transaction which had to be assessed on a case-by-case basis. The ad hoc nature of these arrangements placed issuers and thus investors at a competitive disadvantage relative to conventional equivalents. The complete absence of commercial *sukuk* issuance restricted the funding available to Islamic financial institutions and accordingly affected Muslim consumers and businesses from accessing *sukuk* funds.[765] Moreover, the uncertainty surrounding the tax treatment of *sukuk* threatened the UK's objective of creating a leading Islamic financial centre.

---

[763] HMRC, "Stamp Duty" (2008), 14.

[764] FSA & Treasury, "Consultation (Sukuk)" (2008), 22.

[765] Treasury, "Alternative" (2007), 4.

The government announced a specific tax regime for *sukuk* in the 2007 Budget. In Finance Act 2007 section 53 retrogressively introduces an alternative finance investment bond in sections 48 (A) and 48 (B) of Finance Act 2005.[766] Section 48 introduces a number of conditions to be satisfied for an investment product to be treated as an "alternative finance investment bond" and any 'interest-like' payments made or received from the bonds are treated as an alternative finance return. Section 48(A)(1)(d)(ii) requires the bond-issuer:[767]

(ii) to make a repayment of the capital ("the redemption payment") to the bond-holder during or at the end of the bond-term (whether or not in installments), and

(iii) to pay to the bond-holder other payments on one or more occasions during or at the end of the bond term ("additional payments")

In s 48(A)(d)(ii) the Act requires some sort of purchase undertaking in the agreement, with the attendant implications for true sale criteria, but there is no requirement that assets are repurchased at par value.

Section 48A(2)(h) provides that:

(h) the amount of the redemption payment may (but need not) be subject to reduction in the event of a fall in the value of the bond assets or in the rate of income generated by them

Furthermore, with reference to (iii) section 48A(2)(f) provides that additional payments may be:

(i) fixed at the beginning of the bond term,

(ii) determined wholly or partly by reference to the value of or income generated by the bond assets, or

---

[766] Finance Act 2007, s 53.

[767] Ibid.

(iii) determined in some other way.

Therefore, the legislation takes into account the asset-based nature of *sukuk* and allows income to be generated from bond assets, although this can be complemented by other sources.

A further set of conditions demonstrates the government's tax treatment of *sukuk* as a debt instrument. Section 48(B)(2) provides that:[768]

(a) a bond-holder shall not be treated as having a legal or beneficial interest in the bond assets,
(b) the bond-issuer shall not be treated as a trustee of the bond assets,
(c) profits and gains accruing to the bond-issuer in connection with the bond assets are profits and gains of the bond-issuer and not of the bond-holder (and do not arise to the bond-issuer in a fiduciary or representative capacity),
(d) payments made by the bond-issuer by way of redemption payment or additional payment are not made in a fiduciary or representative capacity, and
(e) a bond-holder shall not be entitled to relief for capital expenditure in connection with bond assets.

As will be readily apparent from the earlier examination of *sukuk* in chapter five, the tax treatment of alternative finance investment bonds (AFIBs) necessarily differs markedly from their contractual principles. In (a) the bond holder is not treated as having a legal or beneficial interest in the underlying assets; in (b) the bond issuer (usually an SPV) is not to be treated as a trustee; and in (c) profits are not to be attributed to bond holders, which would otherwise indicate their proportionate legal ownership of the assets (thus requiring taxation). In (d) any payments made to bond holders are not done in a fiduciary capacity, thus preventing an

[768] Ibid., s 48B(2).

ownership scenario from arising; and in (e) bond holders, as non-owners of the asset(s) are not entitled to capital expenditure relief.

From the originator's perspective, *sukuk* are treated as a loan or debt-relationship and tax rules for corporate debt apply. Despite the *sukuk's* equity-like features – or underlying assets – the government treats it as an interest-generating debt instrument.[769] For purposes of corporation tax, *sukuk* are taxed according to the rules on loan relationships; for income tax purposes, *sukuk* returns are treated as if they were interest; and for purposes of capital gains tax, *sukuk* are taxed as qualifying corporate bonds and are exempt from tax if they meet equivalent conditions.[770] This potentially makes *sukuk* tax-deductible and issuers (not note holders) are taxed as if they beneficially owned the assets, which entitles issuers to any capital allowances or tax depreciations for which the assets qualify.[771] With these measures AFIBs were given tax certainty with respect to income and corporation taxes, capital allowances, inheritance tax and capital gains.[772] However, stamp duty land tax (SDLT) was not covered in the legislation so that tax inequalities remained.

Moreover, because *sukuk* often involve the creation of a trust and are thus treated as a collective investment scheme (CIS) under FSMA 2000,[773] the legislation excludes AFIBs from

---

[769] Amin, "Tax Law" (2008), 3.

[770] Treasury, "Sukuk Issuance: Response" (2008), 35.

[771] Amin, "Tax Law" (2008), .

[772] Treasury, "Alternative" (2007), 10.

[773] Financial Services and Markets Act 2000, pt XVII.

tax provisions relevant to trusts or collective investment schemes.[774] In particular, Finance Act 2005 section 48(B)(5) "ensures that alternative finance investment bonds are not treated as a unit trust scheme either for the purposes of the Income and Corporation Tax Act 1988/s469 or the Income Tax Act 2007/s1007 or the Taxation of Chargeable Gains Act 1992". Nor are they treated as an offshore fund. Further, with respect to companies, they are not classified as a ""relevant holding" in a unit trust or offshore fund for loan relationships purposes".[775]

The government issued a consultation document with the objective of resolving SDLT issues relating to commercial *sukuk* issuance in June 2008.[776] Recall that *sukuk* structures, in general, are often backed by underlying interests in property or land – tangible assets that are compatible with an Islamic view of the creation of wealth and value. Conventional bonds do not convey ownership interests to bond holders; bond holders merely have a right to the payment of interest and repayment of principal. Because SDLT is levied on the acquisition of a "chargeable interest", a plain vanilla *ijārah sukuk* would possibly be exposed to the tax in at least three instances. First, the acquisition of an asset by the SPV from the originator would require SDLT to be payable by the purchaser at a rate of four per cent on an asset valued at more than £500,000. Second, the re-purchase of the asset at the end of the *sukuk's* maturity would again invoke SDLT at the same rate. *Sukuk* holders might be liable to SDLT as owners of the

---

[774] Finance Act 2007, s 53 in Finance Act 2005, s 48b(5)(a)(b)(d). Treasury, "Sukuk Issuance: Response" (2008), 36.

[775] Ibid.

[776] HMRC , "Stamp Duty" (2008).

beneficial interest of an underlying asset.[777] Together, these additional SDLT charges would make the issuance of commercial *sukuk* unfeasible.

The Finance Act 2009 created a legislative framework that extended relief to: (1) the transfer of the asset from the originator to the *sukuk* issuer or SPV; (2) the repurchase by the originator from the *sukuk* issuer; and (3) to the issue and resale of *sukuk* in secondary markets.[778] A series of conditions must be satisfied with respect to each specific stage of relief. In particular, stage one requires that the *sukuk* issuers in England and Wales "enter a legal charge over the asset in favour of HMRC"[779] for the duration in which the asset is held by the issuer. The charge should be equivalent in value to the SDLT on the market value of the underlying asset at the time of the transaction.[780] The charge gives HMRC an interest in a charged property so that "in the event of avoidance or default HMRC are able to collect any SDLT and related interest and penalties that become due".[781] In 2010 HMRC amended Finance Act 2003 to ensure that SDLT relief was available for *ijārah sukuk* issuance as was originally intended in Finance Act 2009.[782]

However, competitive disadvantages still remain in the area of value-added tax as *sukuk* investors may be subject to a VAT charge of 17.5 per cent on any rental payments received

---

[777] Ibid., 12.

[778] Finance Act 2009, sch 61; pt III, s 6-9.; HMRC, "Stamp Duty: Response" (2009), 11.

[779] Finance Act 2009, sch 61; pt III, s 6(a).

[780] HMRC, "Stamp Duty: Response" (2009), 11.

[781] Finance Act 2009, sch 61; pt III, s 5(6).

[782] Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010, SI 2010/86, s 3. HMRC, "Stamp Duty Regulations" (2010).

from the SPV and on their purchase of *sukuk*.[783] The government is working with industry practitioners to resolve these additional liabilities. However, the government may be constrained by its European Union obligations, in particular the Sixth VAT Directive, which clarifies the operation of the VAT system throughout the European Union.[784] The Directive was first promulgated in 1977.[785] However, the Directive has since been updated to allow exemptions to certain transactions. Different rates of VAT are permissible as long as these are not less than 15 per cent.[786]

The government's legislative agenda for AFIBs is remarkable in terms of the extent to which the government seeks to accommodate the Islamic financial industry. Some of the ways in which the government has facilitated Islamic financial structures underscores the seriousness of the agenda. Further, legally mandated consultations with the public, from which much of the above information derives, highlight the willingness of the government to approach the regulation of the industry in a highly flexible and adaptive manner. For instance, several early requirements were dropped in response to industry practitioners' concern that such requirements would render the

---

[783] Treasury, "Sukuk Issuance: Response" (2008), 38. Different VAT rates apply to different goods and services. These must be assessed on a case by case basis.

[784] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L347/1. Ahmad, "*Theory and Practice"* (2010), 261.

[785]Council Directive 77/388/EEC of 13/6/1977 on the harmonisation of the laws of Member States relating to turnover taxes – common system of value added tax: uniform basis of assessment [1977] OJ L 145.

[786] Council Directive 2010/88/EU of 7 December 2010 amending Directive 2006/112/EC on the common system of value added tax, with regard to the duration of the obligation to respect a minimum standard rate [2010] OJ L326/1, art 1.

industry uncompetitive.[787] In general, the scale of tax modifications necessary to eliminate disadvantageous tax treatment, and to classify Islamic financial structures according to novel regulatory categorisations, underscores pivotal differences existing between the legal structures of the Islamic and conventional financial structures. Government documents also illustrate the near reflexive approach in forcing Islamic financial institutions to adapt to the conventional tax and regulatory system, which is not designed for Islamic structures; indeed, the government is clearly convinced that a uniform approach to all financial markets provides the most efficient and effective mode of financial services regulation. Section 6.6 examines this topic in greater depth by focusing on the government's efforts in establishing a regulatory framework for *sukuk* securitisations.

6.7 CREATING A REGULATORY FRAMEWORK FOR SUKUK

Government regulatory policy toward AFIBs is designed to introduce legislative changes to align the regulatory treatment of *sukuk* with conventional bonds. The government decided to proceed with a policy of including AFIBs as a specified investment under the Financial Services and Markets Act 2000 (Regulated Activities Order (RAO)) on the same basis as debt instruments and a unique regulatory definition for an AFIB was created for the purpose. This distinctive definition was set out in Financial Services and Markets Act 2000 Regulated Activities (Order

[787] In particular, see HMRC , "Assessment: Sukuk" (2008). And HMRC, "Stamp Duty: Response" (2009), 11.

2001).[788] The regulatory definition is notable for the exceptional requirements regarding AFIB issuances. AFIBs are subject to a reasonable commercial rate of return clause, which stipulates that the amount of additional payments must not exceed an amount deemed to be a reasonable return on a loan of capital.[789] Specifically, it is designed to help prevent equity-like instruments from benefitting from these regulatory permissions, thus preventing regulatory arbitrage, which would disadvantage conventional equity investments. Although a strict limit on the level of interest is not stipulated, the measure clearly reinforces the government's determination to align the regulatory treatment of *sukuk* with conventional debt instruments. Of course, there is no such requirement for conventional bonds.

Under FSMA 2000 the classification of Islamic financial instruments such as *sukuk* has given rise to various complications. As is the case with all Islamic financial instruments, a *sukuk's* economic characteristics, although similar to conventional products, entail legal structures and risk characteristics that are markedly different from their conventional counterparts.[790] For example, consider the steps required in the *ijārah sukuk* that differentiate its structure from a conventional bond. While a conventional bond is a simple debt instrument, a *sukuk* securitisation involves the sale and re-purchase of tangible assets via a special purpose vehicle (SPV). Issues related to ownership in the underlying assets create legal risks for investors. As a result of these considerations, Islamic securities may not be captured under the existing

---

[788] See SI 2001/544, paras 77-78. FSA and Treasury, "Consultation (Sukuk)" (2008), 14.

[789] Ibid., 15.

[790] Ibid.

regulatory framework. Moreover, the challenge is exacerbated by the fact that within the Islamic securities industry, the nominate contracts used in *sukuk* may each have differing risk, legal and economic characteristics. Thus the contracts of *mushārakah, muḍārabah* and *murābaḥah* are generic terms that describe particular types of transactions but do not describe the products themselves. As a result, the same generic contract or conglomeration of contracts may entail fundamentally different financial products in terms of their risk profiles and economic substance.[791] Hence the government strategy of reviewing the economic substance of alternative financial investments reflects the only feasible approach in developing Islamic finance, although it is a policy designed to function within the existing financial system.

Some Islamic securities appear to fall within the definition of a collective investment scheme (CIS) as defined by the FSMA 2000.[792] The CIS is the only product specifically regulated under FSMA 2000, so the regulatory regime is considerably more stringent (equity investments are considerably riskier investments than debt-based instruments and thus attract higher regulatory intervention). Section 235 of the FSMA 2000 describes a CIS as "any arrangement with respect to property of any description […] the purpose or effect of which is to enable persons taking part in the arrangements […] to participate in or receive profits of income arising from the acquisition, holding, management or disposal of the property".[793] It is also provided that such schemes must

---

[791] IOSCO, "Objectives" (2008), 48.

[792] FSMA 2000, s 235.

[793] Ibid.

not be arranged so that participants have day-to-day control over the management of the property. At least one or both of the following characteristics must also apply:

(1) Arrangements must pool participants' contributions as well as profits or income;
(2) The property is managed on behalf of, or in whole by, the operator of the scheme.[794]

The consequences of treating *sukuk* as a CIS arrangement would result in marginally higher on-going costs relative to bond issuers.[795] Moreover, CISs are subject to a wider range of controls and may require authorisation. Authorisation would limit the range of eligible assets for investment as well as gearing and marketing capabilities.[796] Therefore, *sukuk* issuers would be disadvantaged compared to issuers of conventional bonds were they regulated in accordance with CIS rules.

Notably, the government stipulated that AFIBs should be subject to a mandatory listing requirement on a recognised stock exchange. This requirement again attempts to stem regulatory arbitrage by creating a high level of transparency and oversight of AFIBs. The government is concerned that various investments will exploit the legislative loophole and be excluded from the Collective Investment Scheme. The government cites consumer protections for retail investors, in particular, but the loss of tax revenues must feature prominently in the decision. It is not considered to be unduly burdensome as public listing is a pre-requisite of

---

[794] FSA & Treasury, "Consultation (Sukuk)" (2008), 15.
[795] Ibid., 26.
[796] Ibid., 15.

preferential tax treatment.[797] However, conventional bond issuance is not subject to any such requirement. The policy underscores the difficulty in placing *sukuk* within the uniform regulatory framework.

In November 2008 the government announced that sovereign issuance of *sukuk* would not offer "value for money".[798] The decision coincided with a global financial crisis of historic proportions which reinforced the importance of UK sovereign gilt issuance, whereas a sovereign *sukuk* issuance is an as-of-yet untested product with an uncertain investor base. The government was clearly concerned about the long-term costs of debt issuance as the weak economy forced it to raise its borrowing projections.[799] Nevertheless, the government proceeded with implementing regulatory changes on the basis of the above-discussed industry consultations. The issuance of sovereign *sukuk* has been postponed indefinitely.[800]

CONCLUDING REMARKS

The UK government's principal objective in facilitating Islamic financial transactions is to consolidate an Islamic financial hub in the City of London. The UK experience with Islamic finance highlights the process of economic globalisation, which relies on nation-states to erect

---

[797] Ibid., 23.

[798] Reuters, "Gilt" (2008).

[799] Ibid.

[800] At a Norton Rose event Sarah McCarthy Fry MP, Exchequer Secretary to the Treasury, made this announcement. See Norton Rose, "Event" (2010).

legal and regulatory frameworks through which global processes are channelled and orchestrated. It also provides indications of how nation-states respond to global capital flows and their erosion of economic sovereignty.

The UK government also wishes to secure social benefits from facilitating Islamic finance. By offering a sharia-compliant mode of finance it hopes to offer all British Muslims an inclusive financial marketplace, although early indications point to a lacklustre interest in such products. Financial inclusion may also bring informal Islamic financial transactions, such as *ḥawālah* money transfer systems, under the auspices of state regulation.

The UK government's facilitation of Islamic finance within UK law has coincided with a wider debate as to the degree to which faith-based norms and legal systems should be accommodated without prejudicing the rights of all citizens. In particular, the Archbishop of Canterbury, Dr Rowan Williams, addressed this topic in his famous 2008 speech. Yet the low public profile of Islamic finance has allowed the UK government to facilitate Islamic financial transactions with little public opposition.

The government's legislative and regulatory approach toward Islamic finance is designed to facilitate a level playing field that enables Muslims to practice finance in accordance with their faith. It does not show favouritism towards Islamic finance or any other mode of finance, nor does it directly associate "alternative finance investments" with the Quran or the Islamic faith.

The government's method is principally focused on amending the complex UK tax regime for Islamic financial transactions while undertaking relatively few regulatory modifications. The state's strategy is focused on removing tax and regulatory impediments to the competitive practice of Islamic finance. The strategy is neutral with respect to the religious and ethical attributes that Islamic finance espouses. Yet the state's legislative implementation of Islamic finance necessarily adopts certain interpretations of the sharia that may pose sharia-compliance risks.

A UK sovereign *sukuk* issuance would represent a large step forward in facilitating the development of Islamic finance in the UK. Sovereign *sukuk* issuance would strengthen the City of London's bid to attract further commercial *sukuk* structuring and business activity related to the Islamic financial industry. It would offer the industry new liquidity management tools that could potentially facilitate the development of a greater range of sharia-compliant retail financial products.

The industry generally suffers from a shortage of liquid instruments that would allay its asset-liability mismatch between long term partnership investments and on-demand deposit accounts. It has responded to this challenge by investing in more liquid, but less profitable, debt-based contracts such as the *murābaḥah, istiṣnā'* and *salam*. The industry's liquidity shortage is compounded by the underdevelopment of an inter-bank lending market or a lender of last resort. Sovereign issuance may help to foster a liquid secondary market in short-dated *sukuk* certificates that would enable IFIs to meet their liquidity and capital adequacy requirements.

Furthermore, it would establish an industry benchmark and thus foster corporate *sukuk* issuance.

The government has implemented a number of legislative measures that facilitate commercial *sukuk* within the conventional financial system. Such measures, embodied in successive Finance Acts, are directed at levelling the playing field concerning the way *sukuk* are taxed. Notably, the *sukuk* are treated as debt securities for the purpose of taxes.

Finally, the government has enacted various regulatory measures and created a regulatory definition for *sukuk* as a way of regulating these as debt instruments or bonds. These measures are also designed to distinguish *sukuk* from collective investment schemes (CISs) and their higher rate of taxation. Several regulatory requirements apply to *sukuk* that are not applicable to conventional bonds as a way of ensuring that *sukuk* issuances are not gaming the system.

The following chapter deals with UK financial services law more generally, as well as the role of regional and international regulatory standards. The chapter focuses on the legal pluralistic impact that these tiers of regulation exert over Islamic financial institutions.

CHAPTER SEVEN: FINANCIAL SERVICES REGULATION AND THE LAW OF ISLAMIC FINANCE

INTRODUCTION

This chapter examines the nature and role of regulation as a preliminary to the analysis of UK regulation of IFIs in chapter eight. In particular, it focuses on the UK's approach toward financial services regulation and the impact that EU and international regulatory standards have on the country's financial markets. Examples of the impact of international regulatory standards' on Islamic finance are considered.

The following topics are analysed in turn: the theory of regulation; the liberal values that underlie the UK's institutional framework; the role of financial services regulation and the methods of regulating financial markets; the Financial Services Authority and its responsibilities as universal regulator in the UK; competition and the conglomeration of financial services markets; standardisation of international regulatory law including EU standardisation and global regulatory initiatives such as the Basel process; and finally, the mechanics of Basel II capital adequacy requirements and its specific impact upon Islamic financial institutions.

Communities, regions, states and international actors throughout the world each share a different understanding of what regulation means and in what manner it should be applied. In a democratic society, regulation is based on an intrinsic social agreement that legitimises and

gives authority to those instances charged with ordering human affairs in a certain way. According to the republican ideal, democratic regulation is endowed with moral and legal authority through the popular vote of elected officials. Legislatures and governmental apparatuses exist and carry out their responsibilities on the basis of people's consent via the popular vote of their elected representatives. Entrenched constitutions provide the basis for securing citizens from an erosion of their personal sovereignty by establishing a balance of powers between parliaments, executives and judiciaries.[801] Parliaments are charged with enacting regulations that carry the power and authority of law and do so, on the basis of the legitimacy bestowed upon them. Regulation implies coercive limits to peoples' liberties. Yet it depends for its legitimacy and effectiveness on whether society views it as necessary and morally right; in other words, on whether society believes that it fosters the social good.

The following analyses the nature of regulation and the liberal values and principles that underlie Western political and economic institutions. It focuses on the United Kingdom, specifically, although the ideas are general enough to be applicable in differing degrees to most, if not all, democratic states. The ideas examined underlie the institutional basis of the UK financial architecture. Islamic finance is affected by these arrangements and may be negatively affected when the values and ethics it espouses conflict with those of the majority population.

---

[801] Braithwaite and Drahos, "*Regulation*" (2000), 604.

7.1 REGULATION, SOCIETY AND THE INDIVIDUAL

Regulation can be understood in myriad ways, but it broadly connotes the power to implement collective aspirations through the use of law, by providing opportunities and information which people often lack. It can take the form of a specific set of commands, such as when regulation involves the promulgation of a binding set of rules to be applied by a governmental agency responsible for a certain purpose. Or it may be seen as a pervasive influence of the state designed to influence social and economic behaviour. This type of regulation includes command-based regimes, but also includes other methods of influence including economic incentives, e.g. taxes and subsidies; the supply of information; deployment of resources; franchises; contractual powers; and so forth.[802]

Two broad trends characterise the different ideological perspectives concerning the appropriate role of regulation. The first argues that regulation should be constructed so as to ensure an individual's autonomy or freedom. Opportunities for self-determination and self-governance are the highest goals of this perspective. This viewpoint is often antagonistic towards government intervention in the economy on the basis that an individual's liberty is undermined. Accordingly, people should not countenance unjustifiable constraints on the free development of their individual beliefs and preferences.[803] In fact, the government should safeguard and even

---

[802] Baldwin and Cave, "*Regulation*" (1999), 2.

[803] Sunstein, "*Revolution*" (1990), 40-46. A very interesting depiction of these values is powerfully conveyed in Rand, "*Atlas*" (2007). Rand's philosophy, based on individualism and the rational mind, was

promote different conceptions of the good life as long as these do no harm to others. This viewpoint argues that it is implausible that the government knows better than its citizens what is good for them. Moreover, liberty establishes the freedom to fail and to learn from failure; this represents an important principle in the process of human development. The state's respect for autonomous choice – the belief an individual's highest purpose in human life is to discover for oneself the idea of the Good - is the linchpin of freedom.[804]

The second perspective views autonomy and freedom through the prism of the community or collectivity. Because people's values and decisions are shaped by society, liberty is only realisable if it is nurtured by society.[805] Autonomy resides in decisions reached collectively that decide the course or type of society governments should pursue. Collective self-determination is concerned with establishing and giving effect to the values and identity of the community rather than the individual preferences of its citizens. An individual's wants must be supported by reasons that appeal to the values of the community,[806] and should not be given priority over social goods.[807] Examples of this sort of law-making are environmental law and anti-discrimination law.[808]

---

known as objectivism. Many modern economists and politicians have been influenced by Rand's philosophy, including Alan Greenspan, former Chairman of the Federal Reserve.

[804] Sunstein, "*Revolution"* (1990), 36.

[805] Feldman, "*Liberties"* (2002), 7.

[806] Sunstein, *"Revolution"* (1990), 35.

[807] Feldman, *"Liberties"* (2002), 7.

[808] Sunstein, *"Revolution"* (1990), 35.

Arguably, the legal system should be designed to reflect a combination of the above. First and foremost, it must defend autonomy in the processes of preference formation. Yet liberty cannot be said to be immediately expressed through individual preferences or wants, since preferences are endogenous to available information, legal rules, social pressures and consumption patterns. Instead, autonomy reflects a "full and vivid awareness of available opportunities" on the basis of all relevant information and without illegitimate constraints placed upon individuals and their preference formation.[809] Liberty only obtains when rights "obligate other members of society to make available the resource which each person needs to give effect to his or her choices".[810] Therefore, this perspective requires a bridge to be formed between liberty and different values of equality and social justice. Values of equality and social justice demand that the government improve the life standards of the worst-off groups in society. This may require redistributive taxation systems and welfare programmes, the provision of public services and facilities, and the regulation of the markets – all of which impinge upon the autonomy of members of society.[811] Society must not always respect private preferences, or even sub-group preferences, because such interests may not always be beneficial for society as a whole. An example concerns the 2008 subprime mortgage crisis and the derivatives practices that helped foster a global economic recession. Should the individual wants and preferences of investment bankers be safeguarded when society's welfare is negatively impacted as a result?

---

[809] Ibid., 40.

[810] Feldman, *"Liberties"* (2002), 12.

[811] Ibid., 13.

Society has an interest in determining which private interests can be accommodated without undermining social welfare. Therefore, private interests are sometimes overridden by collective aspirations or considered judgments, often embodied in the democratic process of deliberation in which shared goals best reflect society's hopes and existential needs. Regulation can be justified even if some individuals are made worse off as a result.[812]

The proposal heard amongst some fervent proponents of Islamic finance to erect a dual system of Islamic financial regulation provides a useful example. Islamic finance may enable devout Muslims to engage in the financial marketplace and thus fulfil their financial ambitions without hindrance from the state. However, a dual regulatory system would also have consequences for the entire financial system. It might lead to opportunities for regulatory arbitrage, or claims of unequal and discriminatory financial practices. For example, financiers may exploit loopholes designed to facilitate Islamic finance to the disadvantage of conventional finance, leading to an unlevel playing field.

From a legal perspective, theories of regulation begin with an exposition of the law of property and the law of contract, which establish the basis for state intervention in capitalistic economies. The law of property originated in Roman law as "a person's all-embracing legal power over a tangible object".[813] The notion of private property changed property's social function entirely and fuelled the transition from feudalism to capitalism. The means of production became an

---

[812] Sunstein, *"Revolution"* (1990), 46.

[813] Renner, "*Institutions"* (1976), 81.

object of private appropriation;[814] each producer gained the power to exclude others from resources necessary for the productive process, and from the fruits of that labour. The law of private property establishes these interests, and the law of contract secures the processes required for resources to be allocated to their most valuable use. Contracts provide the institutional support by which agreements are able to be carried out. Therefore, the aggregate of private interests gives rise to social welfare; individuals are empowered to exploit and enjoy society's resources.[815]

The notion of social welfare takes on a subjective meaning within the context of public law. It not only reflects a society's views concerning private property and the allocation of resources, but the political, historical, cultural, even religious traditions that have given rise to this ordering. Criminal law is established to safeguard this welfare. It is employed to maintain order and defend the person, property, and liberty against aggression. Institutional arrangements are catered for in constitutional law, which establishes rights for the exercise of these powers, and "for the formulation, adjudication, and enforcement of private rights".[816]

Now that the general concept of regulation has been discussed the examination of values in the UK economy is the present focus.

---

[814] Santos, "Modes" (1985), 91.

[815] Ogus, "*Regulation"* (2004), 23-26.

[816] Ibid., 26.

7.2 LIBERAL VALUES IN THE ECONOMY

International political regimes, such as the Basel process, the 'Washington Consensus' or the Bretton Woods agreements, represent instances of political authority which embody "principles about fact, causation, and rectitude, as well as political rights and obligations that are regarded as legitimate".[817] The creation and continued modification of these regimes underscore the internationalisation of political authority, but their factual existence does not explain the effects they have on economic transactions. The inventory of such regimes says little about their "generative grammar" - the principles which underlie their order and meaning.[818] To understand the determinants of economic transactions the deeper roots and meanings of such regimes must be examined.

The UK government's facilitation and regulatory approach to Islamic finance is premised on the principle of equality, which holds that "like cases should be treated alike and different cases differently".[819] Equality belongs to the set of values which engender a modern politics of universalism, emphasising the equal dignity of all citizens, and substantively geared toward the equalisation of rights, entitlements and obligations.[820] In the UK and the EU legal intervention has not been aimed at defining a substantive equality which, in practice, is accepted as impossible. Rather it is directed at minimising the inequality of opportunity in education,

---

[817] Ruggie, "Embedded Liberalism" (1982), 380.

[818] Ibid. See also Ruggie, "Continuity" (1983).

[819] Feldman, *"Liberties"* (2002), 133.

[820] Taylor, "Multiculturalism" (1992), 44.

housing, employment and the acquisition of goods and services.[821] The government strives for the creation of a society without “first-class” and “second-class” citizens; it seeks to create a procedural form of non-discrimination, blind to the differences of its citizens, whether they are Christian, Muslim, Jewish, atheist, female, male, homosexual or heterosexual, and so on. However, implicit in this policy is the assumption that its principles are based on neutral, difference-blind principles when, in fact, it is the political expression of a certain social understanding;[822] it is dependent on a moral judgment concerning the unacceptability of inequality with respect to these types of criteria.[823]

In other words, states cannot help but give partial establishment to the norms and values of a culture and this culture, usually reflects the majority population.[824] These “define the meaning and identity of the individual, and the patterns of “appropriate” economic, political and cultural activity engaged in by those individuals”.[825] Here institution is defined “as a broad patterning of social structure and activity around general rules”, although uncertainty surrounds the nature of such rules. Institutions embody the purposes and legitimacy of states, organisations, professions, and interest groups while demarcating the boundaries of activity appropriate to each.[826] The institutionalisation of a society’s values is the process whereby a given set of units

---

[821] Feldman, *“Liberties”* (2002), 135.
[822] Taylor, "Multiculturalism” (1992), 44.
[823] Feldman, “*Liberties”* (2002), 135.
[824] Shachar, “*Multicultural”* (2001), 23.
[825] Meyer et al., "Ontology” (1987), 13.
[826] Ibid.

and patterns of activity come to be normatively and cognitively held in place, and in practice, taken for granted as lawful, although these may be customs and cultural knowledge. Viewing societal institutions in this manner exposes the myth that the capitalist environment of actors including states, regulatory bodies and conventional financial institutions are a priori, neutral elements of modern social processes. Instead societal institutions should be seen as socially constructed and highly problematic. Their actions reflect an enactment of broad institutional patterns rather than autonomous, intrinsic choice, motivation and purpose; a finding very much opposed to an autopoietic view of the law or social systems, in general.[827]

Therefore, despite the multicultural makeup of the UK, the majority population's values and norms are deeply embedded within the institutions of the state. In particular, when the economy of the United Kingdom is examined - as well as other states' economies to varying degrees – a distinctive form of liberalism has emerged since Margaret Thatcher's terms of office as Prime Minister from 1979 until 1990. This liberalism holds that there are no better mechanisms, as general political institutions, to determine equal treatment than the two main institutions of our modernity: a free market to decide what goods shall be produced and how they shall be distributed; and representative democracy to determine what conduct shall be prohibited or regulated so that other conduct can be made possible and convenient.[828] The prototypical neo-liberal believes that each of these institutions provides a more egalitarian settlement than any

---

[827] See Luhmann, "*Aufklaerung"* (1970); Luhmann, "*Aufklaerung 3"* (1991); Teubner, "*Law"* (1993); Luhmann, "*Systems"* (1995).

[828] Dworkin, "Liberalism" (1978), 130.

other general ordering of society.[829] If the market is made to function efficiently, it will determine a price for each product that reflects the cost in resources of material, labour and capital that might have been used to produce a different good for someone else; this is known as the "opportunity cost". A citizen's distribution of goods and services becomes a function of the personal preferences of others and his own; and the sum of these personal preferences establishes the true cost to the community of meeting his or her own preferences for goods and services. The egalitarian distribution – that is, a perfectly free market – requires that "the cost of satisfying one person's preferences should as far as possible be equal to the cost of satisfying another's".[830] In other words, a free market does not impose value judgments concerning a citizen's preferences – at least within the spectrum of public policy; it does not attempt to decide for others what is good in life.

In contract, religions necessarily attempt to impose certain moral visions and principles upon their adherents and the wider environment with which they come into contact. For instance, the sharia proscribes certain goods and services and requires parties to engage in types of transactions that reflect specific moral understandings of material affairs. Therefore, tension

---

[829] An example of these values in action is illustrated in the conservative government's decision, led by David Cameron, to sharply reduce state spending as a percentage of GDP. The government believes that the private sector will benefit from increased confidence in the economy, as a result.

[830] Dworkin, "Liberalism" (1978), 130-32.

necessarily arises between these ideological and moral visions, since the permissibility of certain behaviours is sometimes viewed in opposing ways.[831]

Since the Second World War a form of economic liberalism, coupled with multilateral arrangements, established a balance between free markets and national constraints designed to ensure domestic economic stability. Following liberalisation of the markets after the jarring oil shock of the 1970s, the ideology of neo-liberalism came to dominate the economic policies of the United States and the United Kingdom. These states, in particular, sought to deregulate markets, promote free trade and foster the creation of free and efficient markets. Furthermore, globalisation and its effects on countries' competitive advantage accelerated the process. Policy-makers responded to these pressures, and the vicissitudes of the market economy, by enabling more flexible market processes.[832]

Neo-liberalism represents a concerted effort to minimise the role of the state. A radical interpretation of the ideology sees the state as a provider of security from internal and external threats and nothing more. Citizens of a state should enjoy the right to non-intervention in their lives but not the right to goods. The state should take no responsibility for ensuring that people are able to exercise their liberties.[833] Harking back to classical economic theory, neo-liberalism proposes that "human well-being can best be advanced by liberating individual entrepreneurial

---

[831] For a very interesting and provocative illustration of these ideological differences see Khan, "Development" (2010).

[832] Fazio, *"Harmonization"* (2007), 148.

[833] Feldman, *"Liberties"* (2002), 11.

freedoms and skills within an institutional framework characterised by strong private property rights, free markets, and free trade".[834] But beyond creating and preserving an institutional framework appropriate to such practices, the state should not intervene in the market. Market interventions distort market signals, i.e. prices, interest rates, etc., as these are the result of powerful interest groups whose self-serving interests interfere with the natural course of trade.[835] Hence, market forces are valued as an "ethic in itself, capable of acting as a guide to all human action, and substituting for all previously held ethical beliefs".[836] The regular use of descriptive guides such as "level playing field" and the policy of "neutrality" are key operating concepts in the neoliberal economic landscape as these principles reflect a devoted belief in an unfettered market. Indeed, the hegemony of neo-liberalism is so pervasive that its incorporation into people's common sense manner of living, thinking and understanding the world almost goes unnoticed.[837]

The most important question for this analysis is whether Islamic finance can function on its own terms within the neoliberal economy, for neoliberal values and Islamic values concerning the economy may not always be compatible. The next section examines the regulation of financial markets, in general.

---

[834] David Harvey, "*Neoliberalism"* (2005), 2.

[835] Ibid.

[836] Ibid., 3.

[837] Ibid.

7.3 THE REGULATION OF FINANCIAL MARKETS

The challenges of implementing Islamic finance in the UK economy become evident by examining the economic imperatives of financial services regulation. Most important is the fact that regulation is designed to shore up confidence or trust in the financial system and thus mitigate systemic risk. In this important respect, the regulation of Islamic financial institutions proceeds from the same substantive economic premise.[838] The following discussion is focused, in particular, on the regulation of banks in the financial system.

7.3.1 THE OBJECTIVES OF FINANCIAL SERVICES REGULATION

Financial services regulation is principally concerned with maintaining financial system stability in light of banks' important role as financial intermediaries and linchpins of the payments system. In particular, deposit-taking institutions act as lenders. Through loan origination they transform risks into different maturities. Banks usually create long-term, illiquid assets, which are financed by accepting short-term deposits. This results in an asset-liability mismatch in retail deposit-taking institutions; it differs from the securities business, for example, which accepts investments that are not guaranteed, so that market risk is effectively transferred to the investor. Furthermore, banks operate as agents within a network of other institutions as facilitators or clearing houses of market transactions based on a variety of mediums of

---

[838] Ainley et al., "Islamic Finance" (2007), 13.

exchange. The failure of one single agent in the payments system poses dangers for the entire system.[839]

Other pertinent reasons include the need to maintain consumer confidence; and a consumer demand for regulation that offers the investor a degree of assurance and overall lower transaction costs. Generally, the case for the regulation of retail financial services is stronger than the case for regulating the wholesale market. This is due to greater information asymmetry in retail transactions than in wholesale ones. Moreover, retail markets are easier to regulate than wholesale services in the sense that wholesale business tends to 'disappear' to less constraining regulatory environments.[840]

Therefore, three core regulatory objectives are pursued in devising financial regulation: (1) sustaining systemic stability; (2) maintaining the safety and soundness of financial institutions; and (3) the protection of the consumer.[841] These objectives give rise to two general types of regulation: prudential regulation, which focuses on the solvency, safety and soundness of financial institutions; and conduct of business regulation, which largely focuses on how financial firms conduct business with their customers.

---

[839] Koendgen, "Regulation" (2002), 29.

[840] Kay, "Regulation" (1988), 41.

[841] Goodhart et al., "*Regulation*" (1998), 4; Llewellyn, "Rationale" (1999), 9-10.

Regulators have several instruments at their disposal to fulfil their regulatory objectives. These are generally classified according to the level of market intervention. Accordingly, low intervention is associated with the regulation of information. It forces suppliers to disclose details concerning the quality of their goods and services; further, it can be carried out in the form of private regulation, which imposes obligations but can only be enforced by those for whom the benefits of regulation have been devised. Economic incentives may also induce information disclosure by market participants. Second, a medium-level degree of intervention is often referred to as command-and-control, in which standards are supported by criminal sanctions on non-compliant businesses. Third and finally, the highest degree of intervention characterises the instrument of prior approval, which prohibits an enterprise from undertaking an activity without a license or express permission to do so from a government agency.[842] The Financial Services Authority, the financial services regulator in the United Kingdom, employs a combination of all three methods in regulating Islamic financial institutions. We will review how it does this in the following chapter.

The greater part of statutory regulation in the financial field relates to consumer protection. Conduct of business regulation's remit is to safeguard consumers in their dealings with financial institutions. This includes mandatory information disclosures, ensuring the honesty and integrity of firms and their employees, standardising the level of competence of firms providing financial services and products, ensuring fair business practices, and maintaining fair, transparent and

---

[842] Ogus, "*Regulation*" (2004), 4-5.

honest marketing practices.[843] The risks of consumers' adverse selections are mitigated by capital requirements which ensure that financial institutions have at least some minimal provision of resources available to honour their commitments to consumers. Moreover, capital requirements are intended to mitigate moral hazard by requiring owners of a financial institution to have a stake in ensuring that the firm conforms to conduct of business rules and does not engage in fraud – if merely to avoid fines and/or loss of equity value.[844]

Problems of customer protection within the financial services field tend to be more severe than in other professions.[845] Money is at risk, and the opportunity for fraud and principal-agent conflicts of interest requires a strong regulatory regime, particularly in the area of retail banking as opposed to the wholesale market.[846] In general, the confidentiality or secrecy typically associated with financial services transactions contributes to a greater likelihood of fraud.[847] This is an acute problem in Islamic financial intermediation, particularly with respect to principal-agent conflicts in various forms of partnership investments.

Many factors shape consumer behavior, but the known existence of asymmetric information can reduce consumer demand for goods and services. Consumers know that good and bad products and firms exist on the market, but they lack credible information to distinguish them at

---

[843] Llewellyn, "Rationale" (1999), 11.

[844] Herring and Shuermann, "Regulation" (2005), 19.

[845] Goodhart et al., *"Regulation"* (1998), 7.

[846] Llewellyn, "Retail" (1995).

[847] Goodhart et al., "*Regulation"* (1998), 7.

the point of purchase. For example, Muslim consumers of financial products take a particular interest in the sharia-compliance of the investment products they wish to purchase. A growing body of evidence supports this conclusion, and further suggests that particular groups of Muslim consumers are not convinced that some Islamic financial product offerings have achieved this standard. Hence, the issue of confidence and trust in these specialised products plays a significant role in how the industry will fare. Generally, the price that buyers of products will pay reflects the average quality of products in the market, ranging between good and bad. Sellers of high quality products, who know that their products are good, may refuse to sell their products at a lower value. Sellers of low quality products, on the other hand, will be satisfied to accept a price reflecting an average value since they are aware that their products are of poor quality.[848] For their part, some consumers may respond to poor quality products by decreasing spending or exiting the market altogether. In the most extreme scenario the market may break down completely. Known in economic theory as the *adverse selection* problem, the case exemplifies the importance of transparency and disclosure in markets. Consumers may decide to forgo purchases of high-quality products simply because of their aversion to the high risk and high cost of purchasing a poor product. Thus an additional role of conduct of business regulation consists in setting minimum standards to prevent or remove low-quality producers from the market. In fact, good-quality businesses tend to support these standards so that poor-quality producers are not in the position to tarnish their reputation and economic performance.[849] Our subsequent analysis of the UK government's position with respect to the sharia-compliance of

---

[848] Mishkin, "*Economics"* (2004), 176.

[849] Llewellyn, "Rationale" (1999), 25-26.

Islamic financial offerings raises questions whether the UK's conduct of business regulation procedures are adequately designed to shield investors from low-quality products.

Prudential regulation is designed to ensure a stable financial system. A stable financial system is necessary to provide a favourable environment for efficient resource allocation and the promotion of economic growth. Prudential regulation is directed against systemic risks. It is designed to address banks' special position in the financial system – their role in providing liquidity and their management of the payments system.[850] Bank lending has the function of augmenting or constraining the money supply, as the recent "credit crunch" and current economic situation illustrate. In this important sense, banks act as extensions of the government's monetary policy.[851] A major function of banks as financial intermediaries consists in their role as delegated monitors in a world of asymmetric information between those seeking funds and those who supply them. In some cases, information cannot easily be obtained by outsiders. Its production may require a significant outlay in funds or an extensive and continuous relationship with a firm. Important savings can be achieved in these circumstances by delegating certain functions to financial intermediaries. The financial intermediary's costs are reduced by avoiding duplication of these functions; these consist of gathering relevant information prior to securing a funding decision and monitoring borrowers' actions once they have committed to their investment projects.[852]

---

[850] Ibid., 13; Davies and Green, "*Regulation*" (2008), 16.

[851] Koendgen, "Regulation" (2002), 32.

[852] Santos, "Commercial Banks" (1998), 4-5.

Therefore, banks occupy a pivotal role at the centre of the financial payments network. A large, systemically important bank's failure may result in a domino effect or contagion across the financial sector as a whole. The failure of one insolvent bank can cause depositors of other banks – though they might be solvent – to withdraw their deposits. Thus it is possible to cause a solvent institution to become insolvent because the vast majority of bank assets are not easily marketable or liquid. On the one hand this scenario is indicative of the importance of consumer confidence in the market, and on the other it reflects the pivotal role of market players' perception of the viability of specific financial institutions in a bear market (an extended period of time over the course of which the stock market has declined significantly). The degree of confidence, or lack of it, permeates nearly every institution to some extent.

A recent example provides a terrifying depiction of the reality of this market characteristic. Bear Stearns, the global investment bank, had nearly $18 billion in cash reserves. It was brought to near ruin in a "run" that was not the result of a criminal indictment or some mammoth quarterly loss, but of rumour and innuendo – a dramatic and erosive loss of confidence in the institution's liquidity.[853] It required the unusual assistance of the US Treasury Department to fashion a deal in which Citigroup acquired Bear Stearns for a paltry $2 per share – an enormous loss of equity in one of the world's largest investment banks.

---

[853] Burrough, "Bear Stearns" (2008), 1-2.

A lesson from the Bear Stearns' incident is that banks' marketable assets may dramatically decline in value due to panic. If a bank run does occur, banks are forced to dispose of assets, which cannot be sold off at par value as potential buyers impose high risk premiums on the purchase price.[854] Commonly referred to as *asset liquidity risk*, this scenario represents "the risk that an entity will be unable to unwind a position in a particular financial instrument at or near its market value because of a lack of depth or disruption in the market for that instrument".[855]

Two factors underpin this dynamic: First, a critical problem lies in conventional banks' solicitation of debt contracts for liquid deposits. These liquid deposits finance the acquisition of illiquid assets of uncertain value while the redemption value of the deposit is independent of the performance of the bank or the value of its assets. Second, the value of a bank's assets cannot be traded with confidence within a secondary market or to another financial institution. The value of such assets on a going-concern basis is linked to insider information within the bank that is based on a borrower's payment history and long-term relationship with the bank. Thus an asymmetric information problem exists where outsiders are unsure of banks' underlying assets. A liquidation or break-up of the bank would cause the banks' assets to be valued significantly lower than on a going-concern basis, hence Bear Stearn's $2 share price.

---

[854] Llewellyn, "Rationale" (1999), 13-14.

[855] Joint Forum, "Risk Management" (2001), 23.

Moreover, the failure or even significant losses of one bank may then cause outsiders to wholly revise their view of the value of other banks' assets.[856]

A substantial spill-over effect may ensue on the 'real' economy. Further, the aggregate capabilities of bank employees may be lost if banks are liquidated, resulting in fewer specialists able to distinguish between good and bad assets. The result is a sharp decrease in the amount of lending, and severe recession in the overall economy.[857] This theoretical description of the loss of confidence in a financial institution and its subsequent consequences provides a remarkably accurate portrayal of the steps leading to the global financial crisis of 2008 – the most severe financial crisis since the Great Depression. In practice, these considerations are also applicable to Islamic financial institutions. However, the LIF prevents IFIs from engaging in some financial activities such as derivatives trading that contributed to the financial crisis of 2008.[858] Yet IFIs are susceptible to a set of different risks, including sharia-compliance risks, and these have the potential to undermine consumer confidence. This topic is analysed in sections 8.1 and 8.4.

---

[856] Schoenmaker, "Contagion" (1996), 87; Dockey et al., "Contagion" (1997).

[857] Herring and Shuermann, "Regulation" (2005), 20.

[858] A recent study by Čihák and Hesse found that (1) small Islamic banks tend to be financially stronger than small retail banks;(2) large retail banks tend to be financially stronger than large Islamic banks; and(3) small Islamic banks tend to be financially stronger than large Islamic banks. See Čihák and Hesse, "Stability" (2008), 1.

7.4 THE FINANCIAL SERVICES AUTHORITY (FSA)

The previous section examined conventional regulatory objectives and instruments for regulating financial markets. The United Kingdom and its particular system of financial services regulation is the present focus which, as observed, is underpinned by liberal economic values.

The abolition of the FSA, as well as the agreement in November 2010 amongst G20 states to conclude a new Basel III Accord, highlight the dynamic nature of financial services markets and regulatory activity. This thesis, however, is strictly limited to regulatory developments that have been implemented prior to November 2010.

7.4.1 THE ABOLITION OF THE FSA

With the election of a conservative government in May 2010, the Chancellor of the Exchequer, George Osborne, announced the abolition of the FSA. Osborne blamed the FSA for not foreseeing the credit crisis, including the weakness of banks such as Northern Rock. He claimed that the "FSA became a narrow regulator, almost entirely focused on rules-based regulation".[859] The new regulator should increase consumer protections by establishing a new Consumer Protection and Markets Authority whose remit is to police all financial institutions and the manner by which financial institutions treat their customers. Prudential regulation will be

[859] Parker and Masters, "FSA" (2010), 1.

centred in a new Prudential Regulatory Authority (PRA), concerned with the safety and soundness of the financial system.[860] The PRA will be housed within the authority of the Bank of England, thus effectively re-establishing the Bank as the principal regulatory authority.[861] Further, a new financial policy committee will be established as a means of shoring up the regulatory system's perceived weaknesses to the financial crisis. The agency will seek to prevent credit and asset bubbles from developing and take a holistic approach to financial system stability.[862] On issues in which the regulatory bodies have joint responsibility, the PRA's decision will have greater weight.[863] Furthermore, Osborne established a commission to look into whether banks should be forced to separate their investment banking and retail banking operations, a form of narrow banking that has also been dubbed the "Volcker Rule", as it has been strongly suggested by former Federal Reserve Chairman Paul Volcker in the United States.[864] The results of the commission's report may trigger further regulatory and legislative restructuring in the near future.[865]

The future restructuring of the FSA and other changes will affect Islamic finance's future in the UK economy. However, changes in direction are likely to impact on large-scale decisions such as whether to issue a sovereign *sukuk.* The new government has voiced its support and

---

[860] See Bank of England and FSA, "Authority" (2011).

[861] Masters, "Stability" (2010), 3.

[862] Eaglesham, "Vision" (2010), 3.

[863] Masters, "Stability" (2010), 3.

[864] The "Volker rule" originated with the 1933 Glass-Steagall Act (Banking Act of 1933), enacted in the United States following the collapse of a large portion of the commercial banking system in 1933.

[865] An interim report was released in April 2011. See Banking, "Interim Report" (2011).

optimism for the further development of Islamic finance,[866] but has not yet revealed how this will be translated into practice.

7.4.2 THE STRUCTURE AND REGULATORY APPROACH OF THE FSA

The supervision of financial firms is defined as the complementary process of monitoring and reviewing compliance by financial institutions with regulatory provisions or with other more general standards of prudent and proper behaviour in any particular market. Until recently there was no legal direction in the United Kingdom as the system relied upon self-regulation and administrative discretion.[867] The Banking Act 1979 was the first comprehensive piece of legislation governing the banking sector. In particular, the act established that the acceptance of deposits was subject to specific authorisation by the Bank of England.[868] The City of London reorganised and changed its methods of doing business in the early 1980s due to mounting competition in the global trading system from rival financial centres such as New York and Tokyo. The City had relied until then upon, "a cosy, comfortable, gentlemen's club"[869] style of regulation, with occasional interventions from the Bank of England and the Department of Trade and Industry. It was a light touch, practitioner-based system of regulation which employed a variety of non-legal methods to discipline and gain compliance with acceptable financial standards; a club-type arrangement in which membership of the financial sector was very

---

[866] Rose, "Event" (2010).

[867] Llewellyn, "Universal" (1996), 161; Walker, "*Regulation"* (2001), 1-2.

[868] Llewellyn, "Universal" (1996), 179.

[869] Kay, "Regulation" (1988), 35.

exclusive.[870] Each of the city's professional associations, including the major clearing houses and the stock exchange, were allowed to employ their own methods of discipline against those who transgressed written or unwritten rules. Some of these methods effectively barred banking professionals from further professional practice.[871]

Eventually, the sheer increase in the number of financial market participants and the increasing complexity of international capital markets made the system ineffective. Yet the history of its evolution may shed light on the dynamic constellation of regulatory forces currently impacting upon Islamic finance. A more recent trend has seen the imposition of laws or legally recognised rules at the national level, together with agreed standards at the international level. Moreover, formal legal and institutional structures have been devised within which regulatory and supervisory systems operate.

In 1998 the Bank of England Act 1998 restructured the UK's financial architecture significantly, so that monetary policy became the Bank's chief operational responsibility and supervisory responsibility shifted from the Bank to the Financial Services Authority (FSA).[872] The Monetary Policy Committee of the Bank is charged with formulating monetary policy as stipulated by the 1998 Act.[873] Moreover, in the run-up to the formal establishment of the FSA, a memorandum of understanding between the FSA, the Bank of England and the Treasury was agreed, which

---

[870] Veljanovski, "Introduction" (1988), 3.

[871] Strange, "*Mad*" (1998), 154.

[872] Blair et al., "*Regulation*" (2002), 1-4.

[873] Bank of England Act 1998, pt 2, s 13.

highlights the distinct roles of each organisation.[874] Under paragraph two of the memorandum, the Bank of England is charged with three broad responsibilities. First, the Bank should ensure overall stability of the financial system including stability of the monetary system, financial infrastructure and the payments system. The Bank should see its role in safeguarding the system as a whole, which may include undertaking financial operations in exceptional economic circumstances according to paragraphs 11 to 13 of the memorandum. In particular, the promotion of the United Kingdom's international competitiveness should be achieved through intensive monitoring of the efficiency and effectiveness of the financial sector.[875] For its part, the Treasury is generally responsible for acting as an intermediary in the legislative process.[876]

The FSA gained formal authority over all financial sectors as part of the Financial Services and Markets Act (FSMA) as of 1 December 2001. It is composed of nine predecessor regulators including: the Building Societies Commission; the Friendly Societies Commission; the Insurance Directorate of the Department of Trade and Investment; the Investment Management Regulatory Organisation; the Personal Investment Authority; the Registry of Friendly Societies; the Securities and Futures Authority; the Securities and Investments Board; and the Supervision and Surveillance Division of the Bank of England.[877] Therefore, the FSA became the single regulator with direct supervision of regulated activities stipulated by the act, including deposit-taking, and insurance and investment transactions. The incorporation of predecessor regulators

---

[874] Bank of England, "Memorandum" (n.d.).

[875] Ibid.

[876] Ibid., para 4-5.

[877] Blair et al., "*Regulation"* (2002), 16.

into the FSA represents one of the most significant examples of institutional integration undertaken anywhere in the world. The FSMA was designed to augment this institutional integration with detailed and substantive reform.[878]

The Authority is organised around its regulatory functions, although it generally operates according to a rules-based system in which principles of regulation are imposed and supplemented with detailed rules with which firms must comply in fulfilment of those principles.[879] Yet despite a mammoth body of statutory provision and detailed rules, the British style of supervision is said to be rather informal and quite personalised in that the British prefer "a flexible and differentiated risk-based approach to setting standards and to supervision".[880] This cooperative manner of supervision requires closer proximity to business practice and would thus seem to offer the best practice in terms of detecting and mitigating financial risks. It may, however, pose risks in terms of firms which take advantage of the process's informality and thus pursue regulatory arbitrage opportunities. Arguably, the flexible and differentiated approach to the regulatory environment equipped British policy-makers and regulators to take a relatively early decision to consolidate the development of Islamic finance. By comparison, a number of other countries including France, Germany, Ireland, Luxembourg and South Korea have only recently taken the decision to make the necessary legislative and regulatory changes to enable Islamic financial transactions.

---

[878] Ibid., 16-21.

[879] Mwenda, *"Regulation"* (2006), 12.

[880] Koendgen, "Regulation" (2002), 66.

The FSMA created the statutory framework for the new regulatory and supervisory regime. It provided for the creation of a dual authorisation and permission regime; the introduction of a new definition of regulated activities; enhanced restrictions on financial promotions; the establishment of an enlarged approved persons regime; the creation of the offence of market abuse; and conferral on the FSA of general authority to issue rules and guidance concerning the imposition of day-to-day regulatory requirements on financial institutions and individuals. Moreover, the act granted enhanced enforcement powers including the establishment of an integrated ombudsman, a financial services compensation scheme and a financial services and markets tribunal. The act contains minimal regulatory provision but establishes the basis for the FSA handbook of rules and guidance in sections delineating rule-making and guidance powers, specifically sections 138 through 158. Therefore, FSMA 2000 confers the necessary authority and appropriate powers on the FSA to establish necessary offences and enforce regulatory provisions.[881]

With respect to policies detailing the key regulatory functions of authorisation and permission – the so-called "command and control" level of regulatory intervention, which each UK-based Islamic financial institution in operation has been granted - the FSMA established a system of statutory control based on three central provisions: the general prohibition; the permission requirement; and the restriction on financial promotion. According to part II, section 19, no

---

[881] Blair et al., "*Regulation"* (2002), 37-38.

person may carry on a regulated activity in the United Kingdom unless he is an authorised person or an exempt person. This particular rule applies to the role of sharia scholars in an Islamic financial institution; this point is analysed further in chapter eight. Under schedule 2, regulated activities may include: dealing in and arranging investments; deposit taking; safekeeping and administration of assets; investment advice; managing investments; creating collective investment schemes; and using computer-based technology to provide investment instructions. The requirement for permission establishes that authorised persons carrying out a regulated activity in the UK otherwise than in accordance with permissions granted to him by part IV of the act – permission to carry on regulated activities – or any other provision of this act, is to have contravened a requirement imposed on him by the act. The contravention does not necessarily make a person guilty of an offence, nor does it make any transaction void or unenforceable. However, the contravention may substantiate a lawsuit by the person who has suffered a loss as a result of the contravention.[882] Any person who contravenes the general prohibition of the act is guilty of an offence and liable, on conviction on indictment, to imprisonment for a term not exceeding two years or a fine not exceeding the statutory maximum, or both.[883] Finally, restrictions on financial promotion restrict any person from communicating an invitation or inducement to engage in investment activity in the course of business subject to several conditions and exemptions.[884] The act establishes a high level of intervention in the market; it delineates the necessary offences; and confers on the FSA all

---

[882] FSMA 2000, s 19-21.

[883] Ibid., s 23.

[884] Ibid., s 21.

appropriate powers and authority to enforce the act's provisions. All Islamic financial institutions are subject to these central regulatory provisions.

Therefore Islamic financial institutions are subject to an intensive regime of financial regulation designed to safeguard consumers and the banking system. The following section examines the highly complex financial environment in which IFIs compete.

7.5 THE GLOBALISATION OF FINANCIAL SERVICES

Thus far we have analysed the nature and function of financial services regulation with reference to Islamic finance's place within the UK regulatory environment. Our analysis highlighted the liberal values that underlie financial services regulation. No regulatory architecture is value-neutral. Rather, as noted above, regulatory architectures embody the values and ideological conceptions of the majority culture. In this section we examine the complex international regulatory environment in which Islamic financial institutions compete. Globalising trends in the financial services industry have created a complex and interconnected financial services environment that is subject to standardising pressures. Increasingly, the financial services industry is dominated by major globe-straddling financial institutions whose commercial interests predominate in international standard-setting bodies.

7.5.1 THE CONGLOMERATION OF FINANCIAL SERVICES

All financial institutions, including Islamic financial institutions, are subject to the increasing complexity and growth of international financial markets. These are characterised by larger processes of globalisation, deregulation and integration, which have fundamentally altered the dynamic of international capital markets. Financial innovation has resulted from this mix of forces due to a variety of attributable causes: First, sharp shifts in the pattern of net flows in international savings and investment (as reflected in the distribution of current-account imbalances); Second, a changing regulatory environment especially with regard to deregulating structural rigidities and barriers to competition in national markets, and a new focus on capital adequacy standards of financial institutions; Finally, the widespread application of new communications and computer technology and an explosive surge in competition in international financial markets.[885] Innovation may be attributable to a dramatic increase and dispersion of wealth amongst private individuals, which has fuelled a multitude of new investment vehicles comprising investments of high net worth individuals on an informal, mostly unregulated basis.[886]

Financial intermediation has changed significantly in the past twenty years. Banks are increasingly securitising parts of their loan book, in particular, their stock of mortgages. Their traditional role as financial intermediaries has shifted from taking and holding borrowers' loans

---

[885] BIS, "Recent Innovations in International Banking " (1986), 7-9.

[886] Davies and Green, *"Regulation"* (2008), 8.

on their own books to acting as facilitators of their clients' financial requirements on capital markets. Market operations generally involve trading in derivative markets to achieve an optimal balance of risk and return. This, however, has spurned a dynamic expansion in market trading activities, particularly by banks in large, industrialised countries, which no longer see their primary role or optimal competitive position as one of pure financial intermediation.

Furthermore, a limited range of investment funds and derivatives that were traded in standardised exchanges has given way to creative financial instruments that enable investors to spread risk of all kinds on a much larger scale and in more complex ways. Today an almost unlimited variety of bespoke, over-the-counter transactions (derivatives) such as collateralised debt obligations (CDOs), synthetic CDOs, and the like are held by banks in off-balance sheet vehicles. These vehicles enable investors to spread their risk to a much wider range of risk bearers. Some observers have argued that these structures tend to strengthen the economic system's soundness;[887] but they clearly obstruct regulators' ability to perceive systemic risks as they materialise.[888] Should serious risks arise, the network of these diffuse arrangements may well have an impact across the globe. A contemporary example is seen in the so-called sub-prime mortgage crisis, which began in August 2007 in the US housing market and has slowly spread to the world's major economies and regional trading centres. Sub-prime mortgages had been diced, parcelled and sold off in a multitude of derivative products. A number of very large financial institutions, whose financial stability is pivotal for the entire financial system, acquired

---

[887] Ibid., 7-8.

[888] See Tett, "*Fool's Gold*" (2010).

and traded heavily in such investments. Regulators and policy makers alike claim to have been unable to discern the systemic risks of such activities until the housing bubble burst and regulatory prevention was too late.

Moreover, the globalisation of financial markets has led to a trend where major banks are represented in financial centres across the globe.[889] In fact, the globalisation of financial activity was mostly bank-led through the use of branches or consortia rather than wholly owned subsidiaries. This process of overseas expansion has gradually extended to all forms of business structure as well as the cross-border provision of services in banking and other financial services.[890]

These developments have several consequences with wide-ranging significance. First, traditional divisions between commercial and investment banks hardly exist any longer. Second, banking and insurance institutions now perform many of the same services, although the division remains clearer than between banks.[891] Extended group or conglomerate structures have been created that unify services from multiple areas of activity. The development has created an "almost seamless collection of essentially interchangeable or substitutable savings and investment media".[892] Its implications are such that banks' range of allowable activities has been broadened in the absence of restrictive regulatory barriers. Today, the use of corporate

---

[889] Goodhart et al., *"Regulation"* (1998), 39.

[890] Walker, *"Regulation"* (2001), 8.

[891] Goodhart et al., *"Regulation" (1998),* 39.

[892] Walker, *"Regulation"* (2001), 8.

conglomerate structures has become one of the most dominant business models in the industrial and commercial sectors of many leading financial markets.[893]

Financial conglomeration is a clear strategy for banks to compete both between themselves and with other financial sectors in providing the full range of retail financial services. The major British clearing banks, which include Barclays, Lloyds, Midland and National Westminster, have all become financial conglomerates in both the wholesale and retail markets. Clearing banks now offer all major financial services with the exception of wholesale general insurance.[894]

Indeed, the entire structure of the UK financial system has shifted decisively in the direction of universal banking or the financial conglomerate corporate model. In the UK banks began to engage in securities trading in the mid-1980s and have since become involved in insurance manufacture. Even non-financial companies such as Marks and Spencer - a national retail store – has offered unit trusts or mutual funds, personal equity plans, and consumer loans since 1988. Virgin Atlantic was authorised in the mid-1990s to market its own personal pension, life asSūrance and personal equity plans.[895] Third, the legal and operational structure of banks has become much more complicated. For example, in universal banks or financial conglomerates there are no limits in cross-holdings of shares. Consequently, large numbers of diversified financial conglomerates are created since commercial banks, investment banks and insurance

---

[893] Ibid.

[894] Llewellyn, "Universal" (1996), 180-84.

[895] Ibid., 162.

companies are permitted to own shares in each other (rules limit ownership in non-financial companies due to banks' capital adequacy requirements).[896] Fourth, the increased use of derivatives and off-balance-sheet positions has made the use of occasional or monthly balance sheets unreliable as a guide to a bank's soundness. As a result of these developments, external regulation of conventional financial institutions has become "both less effective and less feasible".[897] The UK's creation of a universal regulatory authority, the FSA, represents a direct response to these commercial developments. Yet the trend is indicative of a global pattern in which a large number of states are opting for more unified regulatory agencies.[898]

The increasing complexity of modern financial markets makes the development of a thriving Islamic financial system exponentially more difficult. In particular, the Islamic financial industry faces the added difficulty of balancing its heritage of ancient Islamic modes of finance with the incessant need to innovate in a wholly different era of financial sophistication. For example, IFIs have generally been prohibited from participating in debt-based derivatives contracts or the sale of debts.[899] This results in the absence of a secondary market for debt instruments and greatly hinders the development of Islamic banking by preventing easy access to liquidity.[900] Secondly, Islamic banks may be prevented from performing their role as a financial intermediary

---

[896] Pelaez and Pelaez, "*Regulation"* (2009), 94.

[897] Goodhart et al., *"Regulation"* (1998), 39.

[898] Fazio, *"Harmonization"* (2007), 150.

[899] Recently, the ISDA/IIFM *Tahawwut* Master Agreement was agreed. It provides a structure under which institutions can transact Islamic hedging transactions such as profit-rate and currency swaps. These are estimated to represent most of today's Islamic hedging transactions.

[900] Chapra and Khan, "Regulation" (2000), 78.

without the ability to securitise their receivables. If an Islamic bank were to help a large client acquire a ship or other large investment as part of its sales-based credit extension, Islamic banks have not been able to re-package such acquisitions into smaller portions and sell these off to the market. The process of re-packaging large credit extensions enables banks to provide large amounts of credit without unduly straining their own capital resources. In so doing financial institutions are able to more easily extend credit to small and medium-sized borrowers who are proportionately disadvantaged.[901] The recent *sukuk* innovation has the potential to alleviate this impediment to some extent by allowing IFIs to securitise their tangible assets and thus to remove these from their balance sheets. However, receivables, which are usually financial and debt-based in substance, are generally not able to be securitised.[902]

The state has accommodated trends in competitive, market-driven financial institutions. Regulatory responses to competitive pressures have stressed the importance of new developments in formation, trading and delivery technology, and the evolving business strategies of financial institutions. The shift towards financial conglomeration is not the outcome of regulatory measures specifically designed to bring it about.[903] Yet there are clear instances in which regulatory requirements have dictated the extent of some bank activities and thereby directly influenced the structure and extent of banking activities. For example, securities trading and insurance manufacture must be conducted through subsidiaries with dedicated capital,

---

[901] Ibid., 87.

[902] Scholars have permitted the securitisation of *murābaḥah* and other debt-based contracts, but only to the extent that they do not comprise the majority of a securitisation's underlying assets. See chapter 5.

[903] Llewellyn, "Universal" (1996), 163.

which establishes a “fence” between different types of risk. It is questionable, however, whether the compartmentalisation of risks is a real safeguard to bank solvency or simply a cosmetic feature since banks – extremely conscious of their reputations and market confidence – would not readily allow a subsidiary to fail. Secondly, regulators may encourage the creation of a conglomerate structure so as to guard against actual or perceived conflicts of interest, which may be of crucial importance to the peculiarities of Islamic financial institutions as our subsequent discussion will shed light on. Thirdly, corporate compartmentalisation enables functional regulation as opposed to institutional regulation to operate more effectively.[904] While the effects of regulation on the structure and nature of financial institutions may, in fact, be profound, the general trend indicates that regulation happens in response to market crises, inefficiencies and/or commercial requirements.

7.6 THE STANDARDISATION OF INTERNATIONAL REGULATORY LAW

Nation-state regulatory frameworks are increasingly subject to regional and international standard setting initiatives designed to minimise the inefficiencies and distortions of global financial markets. These initiatives are conceived and designed by the leading global powers whose conception of the market economy is rooted in their national commercial interests. Globally agreed standards and regulatory initiatives exert strong standardising pressures on Islamic financial institutions to adapt their financial processes according to the conventional mould.

---

[904] Ibid., 167.

7.6.1 EUROPEAN UNION REGULATORY STANDARDISATION

The European Union has acted as a principal engine in the global standardisation process by formally binding EU member states to legislation under EU treaties. Since 2000, EU member states have implemented the Banking Consolidation Directive with slight modifications to account for national conditions. EU Capital Requirement Directives represent a move to codify and give effect to agreements reached at the global level; in this case the Basel II Accord received European-wide compliance.[905] The EU's adoption of Basel I and II blurs the boundary between regional and global banking regulation so that the tendency toward global financial market integration is evident.[906] In accordance with the Second Council Directive of the European Union of 15 December 1989, the United Kingdom implemented the EU Capital Accord within the framework of the FSMA 2000.[907] The FSA establishes an Individual Capital Guidance (ICG) scheme for all banks operating in the UK and makes recommendations based on Basel II requirements.[908]

---

[905] Council Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) [2006] OJ L177;
Council Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) OJ L 177.

[906] Koendgen, "Regulation" (2002), 43.

[907] FSA, "Basel Standards" (2002), 10. Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC [1989] OJ L311.

[908] IBB, "Annual Report" (2009), 27.

EU financial directives encapsulate the Union's overriding objective of creating a single, borderless market. The underlying strategy has sought to remove structural barriers, liberalise capital movements and agree common minimum standards for prudential regulation.[909] The single market has been a market-generated project. In particular, top tier financial firms sought to disband disproportionate obstacles and costs in expanding cross-border business.[910] Early on, participants discovered that the practice of mutual regulatory recognition left a double-regulatory burden for the foreign entity attempting to establish itself in the host country.[911] The EU has effectively solved this problem by "passporting" EU member state-authorised institutions so that they may offer financial products and services throughout the European Union without the need for separate authorisation in each member country.[912] Financial groups, which are not credit institutions, do not benefit from the passporting system. Rather, investment companies are able to offers their products and services on the basis of Council Directive 93/22/EEC.[913] Furthermore, the passporting provision of the directive establishes that the banking activities undertaken by a foreign bank in a host country are not limited by that state's banking model. In fact, the Banking Consolidation Directive is based on the German universal bank model – now a British model of banking as well - in which a whole host of non-traditional banking activities such as securities trading, mergers and acquisitions, and portfolio management are conducted.[914] As

---

[909] Fazio, *"Harmonization"* (2007), 155.

[910] Muegge, "Marketplace" (2006), 21.

[911] Davies and Green, *"Regulation"* (2008), 130.

[912] Ainley et al., "Islamic Finance" (2007), 30.

[913] Fazio, *"Harmonization"* (2007), 156. Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field [1993] OJ L141.

[914] Ellinger et al., "*Banking Law*" (2006), 57.

a result, FSA-authorised Islamic financial institutions are able to offer Islamic financial products and services to the relatively untapped market of approximately 20 million European Muslims. The Bank of London and the Middle East is the first UK-based Islamic bank to have exploited this opportunity,[915] but others have been slow in doing so.

The European Union's position at the forefront of a globalising trend toward regulatory standardisation has been fuelled by the creation of the Euro. The Euro has provided a powerful impetus because it has eliminated exchange rate risk for a vast number of transactions, particularly in cross-border retail business. Furthermore, full enjoyment of the potential benefits of currency union depends on efficient financial institutions, deep and liquid capital markets, and sound, reliable and cheap infrastructure.[916] However, the recent crisis affecting highly-indebted Eurozone countries also exposes a critical lack of common European governance and decision-making authority. The crisis has led some states to act unilaterally in ways prejudicial to the long-term stability of the Eurozone.[917] Nonetheless, the crisis has strengthened market pressures for the development of common economic institutions. As a result, further measures directed toward regulatory and supervisory standardisation within Euro-zone countries are very

---

[915] Ainley et al., "Islamic Finance" (2007), 30.

[916] Davies and Green, "*Regulation"* (2008), 130-31.

[917] For example, Germany's move to ban naked short-selling or Ireland's unilateral decision – in the midst of the global economic crisis - to ensure the full value of banking deposits. See Bloomberg, "Germany" (2011). And Murray-Brown and Dennis, "Ireland" (2008).

strong. These forces will lead to a more coherent institutional framework and eventually impact all financial services institutions operating within EU member states.[918]

7.6.2 GLOBAL REGULATORY INITIATIVES

The Basel Committee on Banking Supervision (BCBS) process is indicative of the trend towards standardised international regulation. It has been described as the herald of international regulatory cooperation across the globe by a non-state administrative actor which seeks to form a response to the dramatic globalisation of the economy.[919] Basel's chief objective, to strengthen the "resilience of the banking sector",[920] is sought by creating international regulatory standards that can be applied to all banks operating internationally or on a cross-border basis. These standards embody certain common minimum rules to which banks operating internationally must comply. In practice and despite the informal Basel process whose rulings are non-binding, the Basel Committee managed to compel its members to fully implement the

---

[918] The alternative is for the Eurozone to fail as a monetary union. Efforts toward regulatory and supervisory standardisation have accelerated in the past year with the establishment of a European Systemic Risk Board (ESRB) and the European System of Financial Supervisors (ESFS) in 2009. While the ESRB's recommendations will be non-binding, the three committees operating under the ESFS – European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority – will have the power to issue binding technical standards; the power to adopt emergency decisions in periods of crisis (such as prohibiting short selling); and authority to authorise and supervise some cross-border European groups such as credit rating agencies and EU central counterparty clearing houses. EC, "Document" (2010); Deringer, "Architecture" (2009), 2.

[919] Zaring, "Law" (1998), 285.

[920] BCBS, "Basel II" (2010).

1988 Basel Accord.[921] The 2004 Basel II Accord represented a continued effort to improve and strengthen international banking standards. It too was negotiated by the G10 industrial countries on the basis of recommendations from supervisory authorities, market practitioners and academics. However, the founding countries of the Basel Committee did not include any of the countries in which Islamic finance is prevalent, and none of these countries were included in either Accord's negotiations.[922]

The Basel process has left a lasting imprint on the international financial system as evidenced by the intention of at least 100 countries to implement the Basel II agreement at varying dates. It is widely acknowledged for its contribution to the widespread use of risk-based capital outlays both as a measure of banks' soundness and as a trigger for regulatory intervention.[923] The accord has become a signpost of a country's commitment to sound and competitive financial markets, albeit with adjustments to local conditions. Members are said to value the non-binding informality of Basel agreements in that these provide flexibility in local implementation – thus enhancing the democratic legitimacy of the agreements. Further, members cannot be threatened with judicial action in the case of non-compliance. Instead the organisation's extra-legal status employs a type of international "soft" law that induces members to comply by "naming and shaming" or extracting reputational costs associated with non-compliance.[924]

---

[921] Zaring, "Law" (1998), 290.

[922] Montanaro, "Islamic Banking" (2010), 113.

[923] Santos, "Regulation" (2001), 42.

[924] Zaring, "Law" (1998), 304.

A pertinent example of the international reach of the Accord can be seen in the Gulf Co-operation Council's focus on many of the most important matters being discussed by the Basel Committee. GCC states have implemented Basel proposals extensively, particularly those concerning capital adequacy, large exposures, derivatives and markets risks, accounting standards and loan provisioning. Moreover, the states have worked towards the potential integration of payments systems, which would create solid regional linkages in an important area of the world. This development marks a significant adoption and implementation of the Basel Committee's regulatory and supervisory recommendations on a global basis.[925]

It also represents a clear instance of what Santos terms "inter-legality". Inter-legality connotes the growing interaction of many different tiers of legal and normative systems – unofficial, local, national, regional, and international - which sometimes conflict and create interference.[926] In the above instance, the GCC states' national legal orders – which are almost all comprised of a mixture of civil law and elements of the sharia – are affected by regional standardisation initiatives in the process of implementing international standards (Basel II). The process of inter-legality testifies to the deep level of global interconnectedness that globalisation encourages. Its impact upon the Law of Islamic Finance may be to exert homogenising pressures upon localised Islamic financial structures - Municipal Laws of Islamic Finance - so that the industry maintains competitiveness.

---

[925] Walker, *"Regulation"* (2001), 63.

[926] Santos, "*Sense"* (1995), 385.

The global recognition of Basel is underpinned by the disciplining forces of the free market as well as the leading positions of Western financial institutions in the global economy. Gulf banks are highly dependent on global capital markets as investment outlets, though – unusually - not as sources of capital. Indeed, more than 70 per cent of their holdings are invested in North American and European markets. These same financial institutions rely on Western banks for their financial expertise and international networks, including their facilitation of short-term liquidity management. Therefore, the necessity to comply with Basel standards confers regulatory legitimacy upon institutions so that they are able to effectively operate in the global economy. [927]

In Malaysia – the largest Islamic financial market in assets - Islamic banks adopted the Capital Adequacy Framework for Islamic Banks (CAFIB), issued by the Islamic Financial Services Board (IFSB) in 2006. The CAFIB is equivalent to the standardised approach introduced by Basel II, which we examine in more detail below.[928]

In the following sub-section Basel capital adequacy requirements are analysed with a view to how they affect financial institutions.

---

[927] Smith, "Islamic Banking" (2005), 170-71.

[928] Bakr, "Basel II" (2008), 26.

7.6.3 THE MECHANICS OF BASEL II

Basel II was agreed in 2004 and relies on three complementary elements or pillars. Firstly, pillar I establishes minimum capital requirements based on the application of risk weights to a bank's assets. In addition to requiring capital reserves for market risk, operational risks are now capital-charged, and emphasis has been placed on the measurement of credit risk.[929] Adequate capitalisation is viewed as a first line of defence in protecting a bank from insolvency and thereby insulating the financial system from contagion. Further, mandating minimum capital adequacy requirements is a means to reduce competitive inequality due to differential regulatory treatment amongst international banks. While increased capital adequacy reserves reduce profits by forcing banks to retain more of their capital, they are also believed to increase the safety and soundness of financial institutions.[930] Most banks have been shown to reduce the scale of investment to incorporate larger capital buffers. In turbulent economic periods banks tend to hold capital above the minimum capital requirements. Yet despite increased reserves in bad times, bank failure is not necessarily lower relative to periods of market upswing. Not surprisingly, with the exception of very small banks, banks have been shown to fail less in economic upswings, suggesting that capital reserve requirements play "a powerful disciplinary role in containing excessive risk-taking during economic upswings".[931]

---

[929] Schoon, "*Islamic Banking"* (2009), 167.

[930] Smith, "Islamic Banking" (2005), 178.

[931] Haibin Zhu, "Capital Regulation and Banks' Financial Decisions" (2007), 18-20.

Secondly, pillar II mandates supervisory reviews, including an assessment of a bank's internal systems and controls, and risk management procedures. This assessment may result in an adjustment of pillar I capital levels. Finally, pillar III calls for more stringent market discipline including detailed rules on disclosure and transparency.[932]

The Accord has retained the basic requirement of banks to hold total capital equivalent to 8 percent of risk-weighted assets. Its chief innovation consists in allowing banks' own internal systems to assess risks as part of the input to capital calculation. A detailed set of minimum requirements provides a framework to ensure the integrity of internal risk assessments. Supervisors are left to judge a bank's readiness to apply its own internal systems as part of the regulatory process. Furthermore, a number of options exist for banks and supervisors in how they deliver the capital requirement for credit and operational risk. Banks may choose the most appropriate approach for their particular operations and financial market infrastructure. These approaches consist of: the standardised approach, which is viewed as appropriate for banks lacking sophisticated risk models; or one of two approaches based on the application of internal ratings known as the foundation or advanced internal ratings-based approaches (IRB). This flexible set of strategies does not deviate from the establishment of minimum capital requirements for internationally active banks, while national authorities may adopt arrangements that set higher levels of minimum capital or other supplementary capital measures.[933]

---

[932] Davies and Green, *"Regulation" (2008),* 43.

[933] Ibid., 44-45.

This is the approach taken by the UK in its recent push to strengthen the liquidity standards of FSA-authorised financial institutions in the aftermath of near financial meltdown. The regime requires firms to increase their liquidity buffers with highly liquid, high-quality government debt instruments such as gilts, highly rated bonds from countries of the European Economic Area (EEA), Canada, Japan, Switzerland and the United States. Further, increased buffers may consist of reserves held with the Bank of England or with the central banks of the countries listed above.[934] These added requirements present an additional challenge to Islamic financial institutions as bonds and central bank reserve facilities are interest-bearing.

Basel differentiates capital into two categories: tier 1 and tier 2 with requirements based on their relative size and relation to assets. Assets receive different risk-weighting treatment according to a standardised risk-grid that assigns greater weight for a bank's business with the private sector as opposed to central governments and for non-OECD states versus those of the OECD.[935] Risk weighting according to the type of counterparty is designed to differentiate between low and high-quality borrowers. Regulatory capital is determined by aggregating all risk-weighted assets and multiplying these by 8 per cent.[936] The scheme potentially restricts Islamic banks from investing in asset classes such as government bonds which appear prominently in banks' balance sheets, particularly in more volatile markets in developing countries. Observers have also noted that IFI's preferred mode of trade financing, the

---

[934] FSA, "Liquidity" (2008), 54.

[935] Smith, "Islamic Banking" (2005), 179.

[936] Schoon, *"Islamic Banking"* (2009), 168.

murābaḥah, may be less competitive since these contracts are geared towards private industry and thus attract a higher capital charge. According to the Basel framework, these instruments would require a risk-weighting of 100 per cent or more, resulting in a relatively higher risk weighting for non-OECD private sector assets.[937] Furthermore, non-financial tangible assets such as copper, houses and automobiles – the preferred assets of *murābaḥah* trades – generally require banks to retain more capital reserves.[938] *Ijārah*-based structures such as those used in UK home mortgage plans are subject to a 50 per cent higher capital risk weighting than a conventional home mortgage, in accordance with Basel II's provisions for mortgage loans on residential properties.[939] The prevalence of *murābaḥah*- and *ijārah*-based contracts in IFIs' balance sheets exposes them to a competitive vulnerability that conventional institutions do not face.

Furthermore, Basel II differentiates significant equity positions from debt-based financing so that the preferred modes of Islamic financial intermediation, the *muḍārabah* and *mushārakah* profit- and loss-sharing contracts, would be characterised as equity positions in the banking book. Equities are more heavily penalised with respect to regulatory capital allotments, since these contracts entitle the holder to a share in the underlying asset which could result in losses. Basel II stipulates that PLS modes of investment should carry a risk weight of 400 per cent, a relatively

---

[937] Smith, "Islamic Banking" (2005), 179.

[938] Bakr, "Basel II" (2008), 26.

[939] Noibi, "Regulation" (2010), 185.

high liquidity buffer. Liquidity costs associated with the capital are passed on to the client,[940] which, in general, makes these modes of investment much less attractive to investors. Our subsequent analysis of the peculiarities of Islamic financial intermediation in chapter eight seeks to provide answers as to whether this uniform regulatory treatment is justified with respect to Islamic finance's unique mode of intermediation.

Basel II introduces counterparty grading (or a risk-sensitive capital regime) so as to distinguish between low and high-quality borrowers. This disadvantages small financial institutions, which are forced to maintain higher capital charges in good times to reduce the level of bank lending. Smaller banks tend to be riskier; they are not able to diversify their asset portfolios to the same extent as large institutions. A larger capital buffer relative to their assets effectively mitigates the build-up of excessive risk-taking. Large banks enjoy a 50 per cent reduction in capital charges unlike the flat-rate required by the Basel I Accord. On the other hand, small banks must stump up 50-60 per cent more capital under the risk-weighted capital regime.[941]

Stand-alone Islamic financial institutions tend to be very small relative to their conventional counterparts.[942] Some observers have remarked that Basel II fosters the consolidation of banks in their efforts to achieve economies of scale. In fact, regulators in several countries, including Turkey, Pakistan, Indonesia and Sudan have either required institutions to strengthen their

---

[940] Schoon, *"Islamic Banking"* (2009), 182.

[941] Zhu, "Regulation" (2007), 20-21.

[942] Chapra and Khan, "Regulation" (2000), 57.

capital reserves or merge to help buttress banks against counterparty risks.[943] However, this tendency is lamented in that consolidated “giants” may harbour systemic threats as these may become “too big to fail” without unleashing systemic ripples. Moreover, big conventional banks operating Islamic windows will enjoy a large advantage over smaller, indigenous Islamic banks[944] and thus be able to dictate the terms of the industry.

In sum, however, the risk-weight capital regime is credited with restoring market efficiency “by linking capital requirements with asset quality”. The flat-rate model did not impose sufficient capital charges on high-risk loans while effectively penalising high-quality investments as these were charged at the same rate as low-quality assets.[945] Nevertheless, the Islamic financial industry has sought differential treatment on the basis that the types of transactions it practices are less risky. Therefore, in 2002 the Islamic Financial Services Board (IFSB), a financial standard-setting organisation based in Kuala Lumpur, was established to promulgate prudential standards for the supervision of Islamic banks. In 2005 the IFSB released two prudential standards; one on capital adequacy and the other on corporate governance.[946]

The strategy of creating international Islamic organisations, including the IFSB, AAOIFI and the International Islamic Financial Market (IIFM), to mediate between established international bodies such as the Basel Committee and the International Accounting Board (IAB) has been

---

[943] Ibid; Shakil, "Basel II” (2005), 162.

[944] Shakil, "Basel II” (2005), 162.

[945] Zhu, "Regulation” (2007), 21.

[946] Archer and Karim, "Challenge” (2007), 3.

adroitly described as a “third way”. The objective of these institutions strives to carve out distinctive standards for Islamic finance while conceding that the industry must integrate into the global economy for it to continue to develop.[947] Hence the organisations’ charters centre on the promulgation of distinctive prudential standards and improved governance and transparency within the Islamic financial industry. These institutions are not unlike the non-national Basel Committee in that they are transnational organisations whose standard-setting efforts are promulgated on a non-binding, informal basis.

Other market forces with galvanising regulatory effect in international capital markets include credit rating agencies, which perform a vetting service for investors. Almost all significant corporate or sovereign borrowers are issued a rating by one of the two major agencies, Standard and Poor’s and Moody’s. These agencies also rate debt instruments including derivatives. Ratings are utilised by regulators to assess the quality of portfolios held by financial institutions, and to determine the amount of capital reserves needed. The Basel II Accord has generated heightened importance for these ratings, particularly in the more sophisticated versions.[948] In 2002 the Islamic financial industry responded to this development with the creation of the International Islamic Ratings Agency (IIRA). However, the industry’s relations with the major ratings agencies have been contentious. Islamic market practitioners complain of having to “meet conventional standards or suffer the consequences”.[949] There is concern that

---

[947] Smith, “Islamic Banking” (2005), 172.

[948] Davies and Green, “*Regulation”* (2008), 67-68.

[949] Smith, “Islamic Banking” (2005), 182.

ratings agencies do not adequately take into account Islamic finance's unique mode of financial intermediation.

7.6.4 BASEL III CAPITAL AND LIQUIDITY REFORMS

Basel III is likely to have a very significant impact upon Islamic financial institutions.[950] Its implementation will considerably increase the quality of banks' capital and significantly raise the required level of their capital. In particular, the agreement calls for core tier 1 capital to increase from Basel II's requirement of 2 per cent to 7 per cent.[951] A new capital conservation buffer comprises 2.5 per cent of the increase. The buffer will be composed of common equity – after the application of deductions like deferred taxes – and will force banks whose capital ratio dips below the buffer to restrict payouts on dividends, share buybacks and bonuses.[952] The agreement raises the total tier 1 capital ratio to 6 per cent from its current level of 4 per cent. Core tier 1 capital is composed of top quality capital such as retained earnings or common equity.[953]

Particularly troublesome for Islamic financial institutions is the intention to implement the world's first set of common liquidity requirements under the agreement. These would ensure that banks

---

[950] Philipp Härle et al., "Basel III" (2010), 5.

[951] Caruana, "Basel III" (2010), annex.

[952] Reuters, "Factbox" (2010).

[953] Caruana, "Basel III" (2010), annex.

have sufficient liquidity so that they would be able to withstand very severe short-term financial shocks.[954] The goal of the new standards is to encourage financial institutions to maintain a prudent short-term liquidity profile. Liquid assets would be comprised mostly of sovereign debt but may also include high-quality corporate debt. Sovereign and corporate debt instruments are interest-based assets, so IFIs will need to make alternative arrangements for fulfilling rigorous liquidity standards.

Higher capital and liquidity requirements are believed to increase the cost of lending incurred by banks without accounting for lending restrictions such as credit rationing. For example, each percentage point increase in the capital ratio increases the cost of credit by 13 basis points. The additional costs of meeting new liquidity standards amount to a 25 basis point increase in lending spreads – assuming risk weighted assets remain stable. However, lower regulatory capital is required as a direct result of banks' holding of low-risk assets, thus resulting in a lending spread of 14 basis points.[955] Some of the costs are likely to be met by increased productivity. Despite these added costs and considerable uncertainty as to the magnitude of the effect, evidence suggests that higher capital and liquidity requirements may significantly minimise the likelihood of banking crises.[956] Some observers argue, however, that increased capital requirements encourage heightened competitive pressures, i.e. banks are forced to carry the same amount of tier 1 capital and thus the rents they offer embody similar cost structures.

---

[954] BIS, "Reform Package" (2010), annex.

[955] BCBS, "Assessment" (2010), 10.

[956] Ibid., 9.

As a result, banks may be encouraged to take greater risks on more profitable parts of their portfolios.[957]

CONCLUDING REMARKS

The theory of regulation centres on different ideological perspectives concerning the content and meaning of liberty. Some argue that liberty cannot exist without augmenting it with economic and social rights that make the fulfilment of one's choices possible. Without these rights citizens would not have the capacity to understand the meaning of liberty. Others see liberty in the absolute autonomy of the individual, unfettered by the state, and wholly free to pursue their own interests and preferences. In practice, democratic countries compromise between these positions by limiting autonomy to the extent that social and economic justice is available to everyone to varying degrees. Regulation involves a trade-off between the objectives of social welfare and the autonomy of the individual. In public law the meaning of social welfare is subjective and depends on a country's history, society, culture and religious values.

In the United Kingdom, liberal values underscore its parliamentary democracy and free market economy, the twin institutions of the modern liberal economy. A prototypical liberal economy does not dictate the preferences or wants of its citizens – although society certainly does

---

[957] Larosiere, "Basel" (2010), 13.

influence an individual's preferences in a number of complex ways. Since the 1980s, however, the UK has fostered a neoliberal economic model that pursues free trade, deregulation and free markets. The neo-liberal creed holds that individuals should be empowered to make their own choices; social welfare represents the aggregate of individual welfare. Islamic finance may struggle to be relevant within this economic framework. In particular, the question arises whether Islamic finance can adhere to the ethical and religious values of the sharia within that system.

The principal objective of financial services regulation is to ensure the stability of the economy and to foster the efficient allocation of resources. Conduct of business regulation is designed to protect consumers from financial practices that take advantage of their lack of information and financial sophistication. Financial institutions, whether they are conventional or Islamic, occupy a pivotal role in the economy and hence are subject to extensive government intervention. In the UK, financial institutions are regulated by the Financial Services Authority, the universal regulatory authority. The UK's historical approach to regulation has been non-interventionist with substantial autonomy delegated to financial institutions. This approach was characterised by a combination of self-regulation and professional oversight within networks of professional associations and business elites. The FSA, a modern regulatory agency formed from nine predecessor authorities in 2000, applies a rules-based approach meant to satisfy regulatory principles according to the specific circumstances of individual financial institutions.

Since the 1980s, deregulation, international free trade and free national markets, amongst other reasons, have fostered an explosive surge in financial innovation and financial market complexity. As a result financial intermediation has undergone fundamental changes. Banks' traditional role as financial intermediaries has shifted from taking and holding borrowers' loans on their own books to acting as facilitators of their clients' financial requirements on capital markets. Market trading activities have expanded exponentially and banks, particularly in large developed countries, no longer see their role as traditional financial intermediaries. Derivatives trading that mostly took place in regulated exchanges has given way to a wide variety of over-the-counter, bespoke financial instruments such as collateralised debt obligations (CDOs), which enable practitioners to spread risk bundles to a much larger number of participants on a global basis. Large financial institutions, which are now globally active, have conglomerated their provision of financial products and services so that retail, investment and insurance functions are provided under one roof. The complexity of the financial environment poses challenges to all financial institutions. Islamic financial institutions are particularly affected by the innovative environment that sometimes conflicts with Islamic principles.

The European Union has been at the forefront of an international effort to standardise regulation across the EU and thus to shore up the imperfections and inequalities of the common financial markets. EU financial directives embody regulatory standards that must be adopted by all EU member states. The EU's Capital Requirements Directive codifies and gives effect to the Basel II Accord. The EU's adoption of Basel I and II blurs the boundary between regional and global banking regulation. The United Kingdom implemented the EU Capital Accord within the

Financial Services and Markets Act 2000. Therefore, Islamic financial institutions based in the UK must comply with the Directive.

The Basel Committee on Banking Supervision (BCBS) is responsible for creating international regulatory standards that embody certain minimum rules to which all banks operating internationally must comply. Despite the non-binding character of Basel standards, most states are compelled to adopt its standards. The 2004 Basel II Accord represents a continuing effort to strengthen international banking standards. Standards were negotiated and recommended by the G10 leading industrial countries. Negotiations did not include a single country in which Islamic finance comprises a significant market share, implying that such standards represent the commercial interests and economic model of leading states.

Basel II capital adequacy requirements establish minimum capital requirements based on the application of risk weights to a bank's assets. Capital adequacy requirements are designed to protect banking systems from bank runs and other systemic vulnerabilities. Adequate capitalisation is viewed as a first line of defence in protecting a bank from insolvency and thereby insulating the financial system from contagion. However, increased capital adequacy reserves reduce profits by forcing banks to withhold more of their capital. Islamic financial transactions require relatively high risk-weightings as a result of the commercial risks associated with commodities trading, the types of non-OECD private-sector counterparts they do business with, and the equity partnerships that Islamic finance favours. Small financial institutions – stand-alone IFIs are generally small – are disadvantaged to the extent that they must retain a

greater proportion of capital relative to their assets than large financial institutions do. The Basel III Accord, recently agreed in the aftermath of the 2008 financial crisis, proposes increased capital requirements and the world's first set of common liquidity requirements. Both requirements will seriously impact the Islamic financial model. The next chapter deals with the FSA's regulation of Islamic financial institutions.

CHAPTER EIGHT: THE REGULATION OF ISLAMIC FINANCIAL INSTITUTIONS IN THE UNITED KINGDOM

INTRODUCTION

This chapter analyses the regulation of Islamic financial institutions in the UK and the challenges that financial services regulation presents for Islamic financial intermediation. It is shown that the FSA's strategy for regulating Islamic banks is guided by a conventional rationale. Namely, the substantive economic risks of Islamic banks and their processes of financial intermediation are the central focus of regulation. The qualitative risks associated with IFI's sharia law-making capacity are not the state's concern. It is asserted that this strategy exposes Muslim consumers to "religious risks" that might result in destabilising financial outcomes.

This chapter is first concerned with the theoretical model of Islamic financial intermediation. Second, an analysis of this model in practice is undertaken. Third, the sharia audit process is reviewed and, finally, the FSA's approach to sharia supervisory committees concludes the analysis.

8.1 THE NATURE OF ISLAMIC FINANCIAL INTERMEDIATION

Regulators must understand a financial institution's risks in order to regulate effectively. Islamic financial institutions and the products they offer comprise a unique cocktail of risks that

distinguish the industry from its conventional peer. These risks arise as a result of the modern Islamic contracts utilised in Islamic financial products as well as the legal, governance and liquidity infrastructure of Islamic financial institutions.[958] Both IFIs and regulators are concerned with designing effective risk management systems that recognise and effectively manage the specific risks in Islamic financial products. In particular, financial institutions must concern themselves with risk measurement and disclosure as a means of fulfilling the new Basel Capital Accord (Basel II) and the implementation of new liquidity standards. [959] Basel II and the recent strengthening of liquidity systems and controls require an appropriate capital buffer depending on the level of these risk measurements.

It is helpful to examine an Islamic financial institution's balance sheet so as to conceptualise the unique nature of Islamic financial intermediation (See table 1 below). On the liabilities side, IFIs accept deposits on the basis of the *muḍārabah*. Deposits/investments are usually offered in current, savings, investment and special investment accounts. Savings and investment accounts are available on a restricted and unrestricted basis. Unrestricted accounts entitle banks to invest depositors' investments according to their own discretion; they do not permit depositors to issue instructions with respect to the object, time period or jurisdiction of the investment. Restricted accounts designate a specific portfolio of investments that are pre-agreed between the depositor and the bank.[960] As *muḍārib* (agent) the bank accepts the

---

[958] Sundararajan, "Risk" (2007), 41.

[959] See FSA, "Strengthening Liquidity Standards" (2008).

[960] Ali, "Islamic Banking" (2011), 7-8.

deposit from the customer (*rabb al-māl*) on the basis that it will retain a pre-specified percentage share of the profits – if the venture is profitable – from its investment of the money with an entrepreneur. In the event of failure the *muḍārib* does not share in any loss attributable to the investment other than his loss of time and effort in locating and contracting an appropriate investment. Further, the *muḍārib* is not allowed to offer any collateral to the *rabb al-māl*. As soon as the contract has been concluded the bank (this time as *rabb al-māl*) is not allowed to monitor the entrepreneur or enforce additional actions by legal devices.[961] Deposits can be made in a multitude of pre-agreed maturities, which range from one month upwards and may be withdrawn either immediately or upon advance notice. Distributions between the bank and depositors are allocated – according to a pre-determined ratio – usually with 80 per cent channelled to investors and 20 per cent to depositors.[962]

Table 1: Generalized Balance Sheet of an Islamic Bank

ASSETS	LIABILITIES
Cash balances	Demand deposits (*amāna*)
Financing assets (*Murābaḥah, salam, ijārah, istiṣnā'*)	Investment accounts (*muḍārabah*)
Investment assets (*muḍārabah , Mushārakah*)	Special investment accounts (*muḍārabah , Mushārakah*)
Fee-based services (*ju'ālah, kafālah*, and so forth)	Reserves
Non-banking assets (property)	Equity capital

Source: Author's Own

[961] Lewis and Algaoud, *Islamic Banking* (2001), 77.

[962] El-Hawary et al., "Regulating" (2004), 12.

Theoretically, these deposits would not constitute a liability for the bank; rather they would take the form of an equity investment. According to the model, an IFI's portfolio of well-diversified assets on the assets side, and equity investment-like profit- and loss-sharing structures on the other, would create a more efficient and stable mode of financial intermediation. The model is often referred to as a "pass-through" method of financial mediation on the basis that IFIs do not carry risk on their banking books associated with investors' deposits, as all risks are carried by depositors/investors, save for misconduct or negligence.[963]

In practice, the actual utilisation of funds by IFIs deviates starkly from the theoretical model. Islamic banks investment of depositor's/investor's funds should undertake to screen potential investment projects on behalf of investors/depositors and thus engage in partnership (*sharikah*). Yet, the typical balance sheet of an IFI shows a clear preference on the assets side for less risky trade-finance assets of considerably shorter maturities such as *murābaḥah, istiṣnā', Ijārah* and *salam* (See figure 1).[964] Trade-based instruments backed by assets and leasing (*ijārah*) products dominate the assets portfolio of IFIs. Together these can constitute 80 per cent and upwards of total assets with the remainder devoted to profit- and loss-sharing investments.[965] The use of short-term trade financing structures backed by real assets minimises the risks of

---

[963] Greuning and Iqbal, "Banking" (2007), 19.

[964] Ibid., 17.

[965] El-Hawary et al., "Regulating" (2004), 18.

verification, moral hazard and adverse selection.[966] Further, vulnerability to liquidity problems on the liabilities side of the balance sheet encourages the use of short-term liquid contracts.[967]

Figure 1 depicts asset compositions from a sample of 30 Islamic banks in 2008 located in countries of Middle East and North Africa (MENA). The *murābaḥah* is by far the dominant mode of financing used by Islamic banks in all MENA countries, accounting for more than 90 per cent in some countries. In others, it figures less than 50 per cent. The average proportion of *murābaḥah* financing across the MENA region is 75 per cent. The *ijārah* contract is the second most utilised structure in Bahrain, Kuwait, Jordan and Qatar. *Istiṣnā'* is the third most popular structure. Only in Saudi Arabia was the *muḍārabah* the second largest mode of financing.[968] Therefore, from an economic point of view, Islamic finance closely resembles conventional financial practices, since its preferred investments are less risky and offer financial institutions greater means of control and hedging opportunities.[969]

---

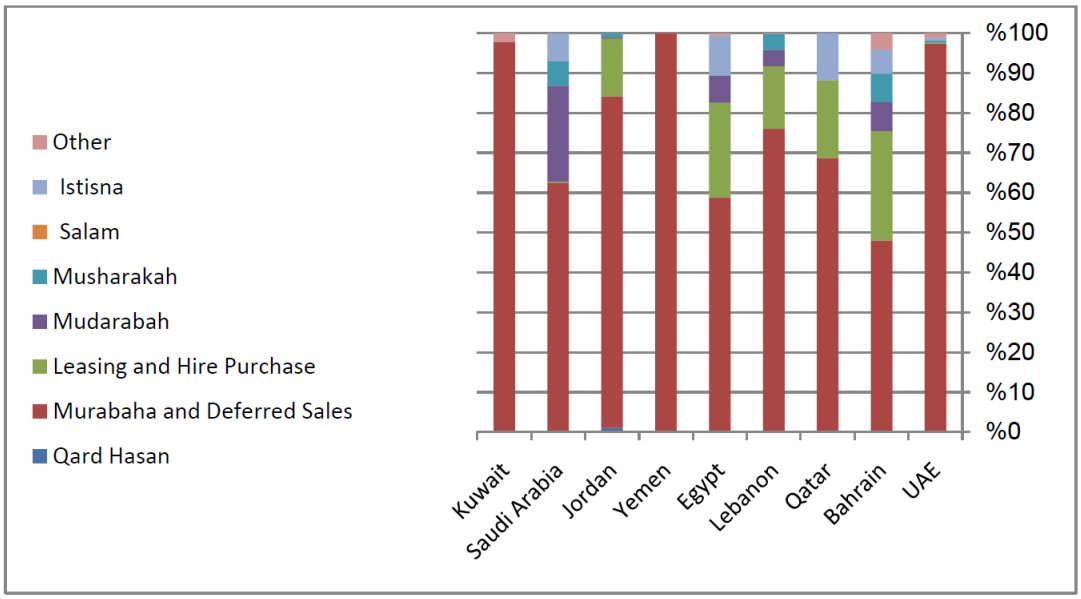
[966] Lewis and Algaoud, *Islamic Banking* (2001), 72.

[967] El-Hawary et al., "Regulating" (2004), 18.

[968] Ali, "Islamic Banking" (2011), 18.

[969] Lewis and Algaoud, *Islamic Banking* (2001), 72.

Figure 2: Percentage Composition of Islamic Financial Structures Across a Range of Islamic Banks in MENA Countries in 2008



Source Ali, "Islamic Banking" (2011), 18.

However, the high concentration of asset-backed trade financing structures limits IFIs' capacity to achieve maximum profitability from their portfolios by narrowing investment options to short-term and less profitable investments. Further, asset-backed instruments expose IFIs to heightened levels of credit, operational, market and exchange rate risks, which pose important questions for regulatory authorities. Recall that these types of investments are considered very risky from a capital adequacy perspective.

From a regulatory perspective, PLS modes of finance may increase the overall level of risk on the asset side of a bank's balance sheet. In particular, the degree of operational risk is a crucial consideration for regulatory authorities. The management of PLS modes of financing requires investment activities that are not normally undertaken by conventional banks. These include the

determination of profit-and-loss sharing ratios from assorted investments as well as the ongoing auditing of investment projects to ensure that projects are properly managed and appropriately valuated. As mentioned earlier, IFIs have no legal recourse to control the investment activities of agents/entrepreneurs. According to *muḍārabah*, agents are entitled to direct the investment activities to the best of their ability. Furthermore, unlike trade-financing transactions, PLS modes cannot be hedged with collateral or other guarantees to reduce counterparty credit risk since the sharia prohibits these.[970]

Known as the principal-agent problem in conventional finance, the separation of management and ownership entails moral hazard, because managers may not possess the right incentives to maximise profits as owners would have them do. The principal-agent problem arises because of the asymmetric information between the manager and the owner; the owners/stockholders of a firm do not possess complete information about the manager's activities and the monitoring process is costly in terms of time and money.[971] Therefore, the fact that the equity contract is a less attractive contract in conventional finance offers a clear indication of why PLS modes of financing in Islamic finance are also underutilised.

On the liabilities side of the balance sheet, PLS modes of financing pose fiduciary risks in the case of misconduct or negligence on the part of the *muḍārib*. In the case of misconduct or negligence a profit-sharing and investment account (PSIA) would lose its equity features and

---

[970] Sundararajan and Errico, "Institutions" (2002), 5-6.

[971] Mishkin, "Economics" (2004), 181-82.

become a liability of the bank, giving rise to prudential concerns.[972] AAOIFI defines fiduciary risk as the act of becoming legally liable for a breach of the investment contract either for non-compliance with sharia rules or for mismanagement of investors' funds.[973] In the case that an IFI were found to be liable for breach of its fiduciary responsibilities toward depositors it could lead to both direct and indirect losses. Indirect losses resulting from damage to its reputation would lead to a decrease in the price of its listed shares. A loss of confidence in the financial institution could lead to a bank run, exposing share holders and investment account holders (IAH) to substantial economic losses.[974]

Furthermore, the sharia requires account holders to bear the risk of loss in the case that the bank's investment loses money. This primary feature, coupled with the information asymmetry via unrestricted account holders, engenders significant moral hazard since banks' incentives are directed toward risk-taking and maintaining low levels of capital.[975] In general, the *muḍārabah* offers a bank's management significant freedom in fund management decisions. Yet there is a total lack of transparency with respect to management's investment choices; with regard to management's ability to alter profit shares as a reward due to the *muḍārib*; in the allocation of liquidity costs between shareholders and investment account holders; and, finally, in the

---

[972] Bhambra, "Implications" (2007), 207.

[973] AAOIFI, *Shari'a Standards* (2004-2005), 232.

[974] El-Hawary et al., "Regulating" (2004), 21.

[975] Sundararajan and Errico, "Institutions" (2002), 7.

management's choice whether losses should be absorbed by internal reserves or whether these costs should be passed on to investment account holders and/or shareholders.[976]

Moreover, banks, in order to offer investment yields competitive with conventional financial institutions, establish profit reserves so as to "smooth" any potential losses from depositors/investors deposits; thus, in effect, negating market risk on the part of the investor.[977] In fact, profit-and-loss sharing investments, which theoretically do not guarantee the value of the deposit, in practice almost never pass on a loss to depositors.[978] Therefore, IFIs' own capital is exposed to investment losses on the assets managed for investors.[979] IFIs may forgo all or part of their share of the profits to be able make these transfers. Known as displaced commercial risk (DCR) this practice varies between countries as some regulators require IFIs to carry virtually all of the risk.[980] The regulatory consequences of DCR leave regulatory authorities uncertain about the consistency of a key product and, indeed, with respect to the Islamic banking model.[981]

In addition to accepting deposits on the basis of profit- and loss-sharing contracts, Islamic financial institutions differentiate themselves from conventional institutions by combining

---

[976] Montanaro, "Islamic Banking" (2010), 116.

[977] Sundararajan, "Risk" (2007), 41-42.

[978] Wilson, "Regulatory Challenges" (2010), 379.

[979] Noibi, "Regulation" (2010), 184.

[980] Sundararajan, "Risk" (2007), 41-42.

[981] Bhambra, "Implications" (2007), 207.

different functions of banking under a single roof. Brokerage, investment banking, and commercial banking form the activities of IFIs, similar to that of the universal bank model.[982] However, universal banks offering conventional products separate fund management and investment operations from commercial banking operations according to function. Further, universal banks erect firewalls to separate investment and commercial financial activities legally, financially and managerially.[983] In practice conventional banks' segregation of banking functions may not protect institutions from systemic shocks such as that of the 2008 financial crisis, but it does minimise inherent conflicts of interest and provide a buffer between banking activities. IFIs conduct the same activities without any such separation which may lead to greater instances of conflict of interest or insider dealing within firms.[984]

Furthermore, current Islamic financial practice pools funds mobilised on the basis of *muḍārabah* with equity holders' capital; thus barriers between different types of accounts are "treated as one large bucket".[985] According to the theoretical model, a clear separation of risks and performance associated with individual investment projects clarifies the rights and responsibilities of all involved stakeholders. In practice, the proceeds of all investments, including demand deposits, are divided amongst shareholders and investment account holders relative to their share of the capital. An investment account holder's return equals the total revenue minus the percentage due to the *muḍārib* or bank's shareholders. Therefore,

---

[982] Greuning and Iqbal, "Banking" (2007), 19.

[983] El-Hawary et al., "Regulating" (2004), 16.

[984] Clode, "Issues" (2002), 69.

[985] El-Hawary et al., "Regulating" (2004), 16.

shareholders and investment account holders must bear the credit and market risks in proportion to their investment. Yet, only the shareholders must countenance operating risks associated with illegal and negligible behaviour by the bank's management.[986] From a regulatory perspective, the fact that different stakeholders carry different risks and thus require different safeguards, may strengthen the argument that uniform regulatory treatment is insufficient or overly restrictive.[987]

While most Islamic banks report these funds on-balance sheet, many banks have placed them off-balance sheet. Those banks that report investment accounts off-balance sheet clearly regard these as fiduciary investments, since risk is borne by the investor. On a global basis regulatory authorities have required different accounting treatments of investment accounts that render financial comparability extremely difficult, if not impossible. Moreover, the variability of this accounting treatment directly impacts capital adequacy requirements, liquidity or treasury management, as well as fiduciary issues with respect to the evaluation of funds transfers between investment account holders' funds and those of equity holders or the bank's own funds.[988] In the UK, financial institutions' annual report and financial statements are undertaken according to International Financial Reporting Standards (IFRS) as adopted by the European Union and implemented in the UK Companies Act 2006.[989] Therefore, the certainty and consistency of accounting treatment in the UK removes the disadvantages of incomparability

---

[986] Montanaro, "Islamic Banking" (2010), 116.

[987] Ibid.

[988] Ahmed, "Issues " (2002), 116.

[989] Benston et al., "*Reporting"* (2006), 93; IBB, "Report" (2009), 10. See Companies Act 2006, s 474 (1).

and greatly facilitates the regulator's task. Questions remain, however, regarding the appropriateness of conventional accounting treatments of Islamic financial products in jurisdictions in which accounting standards vary. Guidelines determining ratios for capital adequacy, other reserves and provisions as well as overall liquidity may be more meaningfully expressed under AAOIFI accounting standards than IFRS.[990]

The next section examines the way in which the Financial Services Authority addresses the unique risks associated with Islamic finance.

8.2 THE FSA REGULATORY APPROACH TO ISLAMIC FINANCE

In the United Kingdom the FSA is confronted with the challenge of determining the appropriate definition of products offered by IFIs. The economic substance and outcome of Islamic financial transactions are generally similar to conventional products while the legal structure varies quite significantly, and, in turn, contains different risks. In particular, the FSMA 2000's RAO may not apply to Islamic financial products and services. This is critical, since the regulatory definition of products determines to whom financial products can be marketed. If a financial product falls outside the regulatory framework, restrictions may arise concerning potential investors. These considerations should prompt firms to consider whether the products they wish to market "can

[990] Ahmed, "Issues" (2002), 122.

be accommodated within the Regulated Activities Order".[991] These considerations underscore the constraints that the established regulatory framework poses to an industry which seeks to alter economic outcomes. If alternative financial transactions are not able to be categorised according to conventional standards, IFIs are restricted from bringing these to market.

Furthermore, section 5 (2) of the FSMA 2000 RAO defines a deposit as a sum of money paid on terms "under which it will be repaid, with or without interest or premium, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it".[992] Therefore, UK statutory law requires "capital certainty" for all bank deposits. Unless a bank is insolvent, it is required to return a depositor's principal plus any interest earned, if applicable. In the case of investment products - other than deposits - in which the return of the principal is not assured, financial institutions are subject to more extensive regulatory requirements as well as more extensive obligations under the FSA's Treating Customers Fairly (TCF) initiative, which provides enhanced consumer protections for retail customers.[993] Furthermore, deposits and retail investments of up to £50,000 are guaranteed in the UK by the FSA's financial services compensation scheme,[994] as required by the Deposit

---

[991] Ainley et al., "Islamic Finance" (2007), 14.

[992] SI 2001/544.

[993] Fiennes, "Implications" (2007), 192.

[994] FSCS, "Compensation Limits" (2010).

Guarantee Scheme (DGS) directive.[995] The directive was implemented in part XV of FSMA 2000, which covers all regulated activities.[996]

The UK deposit guarantee scheme runs up against the sharia prohibition of *gharar*. Furthermore, the scheme invests its funds in interest-bearing accounts and is not structured to segregate Islamic funds from conventional banks' interest-bearing funds. Some states have found solutions to these problems. Turkey has taken pains to engineer a solution by establishing a sharia-compatible deposit *takaful* in which Islamic funds are pooled. Malaysia has also launched a deposit insurance scheme that segregates Islamic deposits.[997] This particular problem has yet to be addressed in the United Kingdom.

The implication for Islamic financial institutions is that they are not permitted to offer profit- and loss-sharing accounts on the liabilities side of their balance sheets in the United Kingdom. Of course, this does not prohibit IFIs from offering PLS modes on the asset side. On the liabilities side, IFIs may offer an account in which a customer's money is invested into a pool from which returns are paid and the capital is guaranteed. In the case of loss, the bank is required, in accordance with the law, to provide funds from its own resources to ensure that customers are repaid in full. Customers are given the right to elect whether they wish to receive full repayment in the case that losses arise and are advised that they will be acting contrary to the sharia, if

---

[995] Council Directive 94/19/EC of the European Parliament of the Council of 30 May 1994 on deposit-guarantee schemes [1994] OJ L135; amended by Directive 2009/14/EC.

[996] Ellinger et al., "*Banking Law*" (2006), 49.

[997] Sole, "Introducing" (2010), 122.

they choose to accept full repayment.[998] Thus, the FSA effectively does not allow PLS modes as deposit-taking instruments. In doing so a whole host of principal-agent risks, including consumer protection issues, are avoided on the liabilities side of an IFI's balance sheet. Further, income recognition policy and the funding structure of ventures, i.e. IFI's profit distribution between investment account holders and shareholders, do not need to be regulated. As long as returns on investment account holder funds and shareholder funds are properly disclosed, market discipline should ensure that appropriate distributions are made. If the IFI, acting as an agent, appropriates too large a share of the profit, its competitors will seek to attract its investors/depositors.[999] Finally, the FSA's prohibition of PLS modes avoids contentious problems related to corporate governance. In particular, investment account holders rightly do not have an interest in shareholder- type rights as long as they are assured of their principal investment. However, the issue continues to bedevil jurisdictions in which investment account holders' equity-like holdings are not allowed participation in the governance of the financial institution.[1000]

In April 2008 the IBB introduced a deposit-taking investment account known as *wakālah* in response to the particular requirements of British Muslim consumers. A *wakālah* is a traditional Islamic contract, the equivalent of agency. The *wakālah* investment account enables depositors/investors funds to be managed individually on a profit- and loss-sharing basis; funds

---

[998] Amin, "Regulation" (2010), 1.

[999] Clode, "Issues" (2002), 73.

[1000] Greuning and Iqbal, "*Risk"* (2008), 193.

are not pooled with the monies of other investors and the bank offers customers an expected rate of return. If, for any reason there are doubts that the expected rate of return will not be achieved, the deposit plus any accrued monies are returned to the customer.[1001] The *wakālah* offers Muslim investors a compromise in the modern economy. Depositors are able to deposit/invest their monies with the assurance that their principal investments will be safeguarded. Moreover, they can take satisfaction in employing a traditional Islamic structure to facilitate their requirements without directly contravening the sharia. Contracts resembling the *wakālah* such as *wadīʿah yad ḍamānah* (guaranteed safekeeping) or *al-qard* (loan) are used as guaranteed principal contracts throughout the industry.[1002]

Yet the concept of profit- and loss-sharing as a means of fund mobilisation – which is the cornerstone of Islamic financial intermediation - is prevented from being fully realised in the UK and in many other jurisdictions. The result is that FSA-authorised IFIs accept deposits in an almost identical manner as conventional banks do. In the event the state's uniform regulatory approach impacts the type of financial intermediation that Islamic finance envisages by preventing it from occurring. The socio-economic values and benefits associated with PLS modes are not realised. On the other hand, however, it is not entirely certain that Muslim depositors/investors truly desire a true profit- and loss-sharing mode of finance. It would be erroneous to assume that a Muslim consumer's desire for religiously authentic products could supplant their need for the stability and predictability of modern financial practices or for returns

---

[1001] DiVanna and Sreih, *"Islamic Finance"* (2009), 45.

[1002] Dusuki, "Murābaḥahh" (2008), 175.

that approximate conventional earnings. While it has been documented that the religious element of Islamic financial products represents the most important factor in British Muslims' uptake of such products, in practice the higher cost of Islamic financial products such as Islamic home mortgages has prevented a vigorous uptake of such investments.[1003]

Other factors besides financial services law are involved in determining the extent to which the LIF is practiced. After all, investment banks may still offer investors PLS modes of investment; these types of investments, however, do not ensure investors' principal amounts. To date no empirical research suggests that Muslim investors' religious and cultural motives for their uptake of Islamic financial products are decisive, so that these same consumers would forgo high and stable returns as offered by conventional banks.[1004] In effect, Islamic banks' decisions to engineer and employ certain types of Islamic financial contracts, some of them tailor-made, are based on ensuring a competitive return for their customers. In sum, Muslim consumer/investor decisions are not intrinsically different than conventional preferences[1005] and this is a very significant factor shaping the modern Law of Islamic Finance.

The authorised mode of Islamic banking in the UK highlights the fact that the secular state allows individuals' discretion in whether they choose to employ or adhere to the LIF. Underscoring this fact, conventional institutions operating so-called "Islamic windows" in the UK

[1003] Tameme, "Housing Finance" (2009), 199-201.

[1004] See, in general, Young, "Report" (2008), 40.; Montanaro, "Islamic Banking" (2010), 119.

[1005] Karasik et al., "Islamic Finance" (2007), 390.

are not subject to any separate authorisation requirements other than the permissions and authorisations already obtained as a conventional financial institution. Only if such institutions were to establish subsidiaries or other separate legal entities, would these require separate authorisation to conduct business.[1006] The religious characteristics of Islamic windows' financial offerings are of no direct concern to the state.

This state of affairs evokes the fine balance of an intricately carved social understanding, not wholly dissimilar to that found in other Western countries. The balance affords little room for religion in the public sphere, even though the Church of England occupies a historical and symbolic role as the religion of the state. Instead, the practice of one's religion is deemed a private matter, appropriately undertaken in the privacy of one's own home. Yet this social frame of mind is not in any way exclusive of the consciousness and lifestyle of British Muslims. For example, an integral feature of the social function of Islamic banks concerns the annual calculation and payment of *zakāh* (almsgiving) payments. *Zakāh* is etymologically linked to *zaka* (to be pure), and suggests the idea of growth to underscore the fact that the giving of one's resources represents both a spiritual cleansing of oneself as well as one's property. It is commonly understood as a tax on property rather than income, and is payable only on certain kinds of property, namely those which represent growth or are devoted to growth, actually or virtually. Hence, it is also a means of income redistribution.[1007] The IBB does not undertake this social task on the part of its shareholders; rather it suggests that its own shareholders

---

[1006] Ainley et al., "Islamic Finance" (2007), 12.

[1007] Benthall and Bellion-Jourdan, "*Crescent*" (2003), 9.

should calculate their own private contributions and donate these to their preferred charity.[1008] Sharia Supervisory Boards (SSBs) should, according to theory, calculate *zakāh* obligations on a per share basis as this role figures prominently in IFI's conception of their greater social good.[1009] Therefore, it would be short-sighted and somewhat prejudicial to believe that the social understanding of religion's role in society is limited to the majority population. By implication, it is implicitly agreed that a uniform system of regulation offers the most effective, equitable and legitimate means of meeting everyone's financial requirements and investment decisions. The following section concerns a unique feature of Islamic finance, namely, the sharia audit process.

8.3 THE SHARIA AUDIT PROCESS

The Sharia audit process is an integral part of the corporate governance of IFIs. The SSB is the primary organ responsible for ensuring the integrity and credibility of the IFI by issuing fatwas and auditing the sharia compliance in all aspects of the products, operations and activities of the financial institution.[1010] This includes both the *ex ante* and *ex post* aspects of all IF transactions, which indicates that both the legal composition of contracts and the way in which an Islamic financial product is transacted, must be reviewed for their sharia compliance.[1011] Furthermore, the audit process involves the review of investment policies, the disposal of non-sharia-

---

[1008] IBB, "Report" (2009), 9.

[1009] Schoon, *"Islamic Banking"* (2009), 139.

[1010] IFSB, "Guiding Principles" (2006), para 47.

[1011] Ibid., para 48 (i).

compliant income, the monitoring of charitable activities as well as the calculation and payment of *zakāh*.[1012] An SSB should certify in an annual report that an IFI has complied with the sharia in the all of the tasks outlined above.[1013]

In practice, the internal sharia audit systems of IFIs differ according to provisions stipulated in firms' articles of association or, in some jurisdictions, according to national regulatory requirements. Yet, according to a survey of 13 IFIs, all firms were responsible for their own *ex ante* monitoring of sharia compliance. Only infrequently, did national or international regulators stipulate SSB-rules that detailed specific competencies, decision-making authority and the composition of such bodies.[1014] Regulators who do oversee IFIs' internal sharia auditing processes delegate responsibility for the design and functioning of such systems to IFIs, which allows secular regulators the freedom to regulate these processes indirectly.[1015]

For example, the articles of association of the Islamic Bank of Britain describe its sharia-related supervision accordingly: "It is intended that the business affairs of the company shall be conducted in accordance with Sharia'a. Activities of the Company will at all times be supervised by the Sharia'a supervisory committee. The Directors of the Company are obliged to ensure that the business of the Company is at all times Sharia'a compliant".[1016] This minimal disclosure

---

[1012] Ibid., para 48(ii).

[1013] Grais and Pelligrini, "Sharia Compliance" (2006), 7.

[1014] Greuning and Iqbal, *"Risk"* (2008), 189.

[1015] Bhambra, "Implications" (2007), 202.

[1016] IBB, "Articles" (2008), 9-10.

does not clarify SSB procedures for ensuring these objectives; nor does it offer transparency in how the SSB arrives at fatwas that sanction the products and services it offers, despite the IFSB's recommendations that IFIs do so.[1017]

Sharia scholars should perform regular audits of new products or transactions and issue fatwas, if they are satisfied that the product meets sharia guidelines.[1018] Straightforward products such as *murābaḥah, ijārah* and *wakālah* usually involve minimal oversight due to their relatively standardised forms. However, more innovative and complex products such as *sukuk, wa'ad*-based instruments (derivatives-based hedging instruments) and hybrid sharia structures require direct and prolonged involvement in the development process.[1019] According to the industry, many complex products are channelled through a long development process only to be rejected as *ḥarām,* or forbidden.[1020]

Despite these safeguards, IFIs' sharia audit systems raise serious concerns whether a conventional regulator is equipped to deal with them effectively. In particular, conflicts of interest often surround the appointment of members of the sharia board. The AAOIFI standard for this stipulates that members should be appointed by the Board of Trustees for a four year term[1021] so that SSB members are not subject to any undue influence by the executive management,

---

[1017] IFSB, "Guiding Principles" (2006), para 55-57.

[1018] Grais and Pellegrini, "Sharia Compliance" (2006), 7.

[1019] Shikder, "Islamic Finance" (2009), 30.

[1020] Ainley et al., "Islamic Finance" (2007), 15.

[1021] AAOIFI, *Sharia Standards* (2004-2005), xii.

which should not have the authority to appoint or to dismiss them.[1022] While the application of this standard varies from country to country, according to one survey conducted by the International Institute in Islamic Thought, almost 80 per cent of sharia board member appointments were made directly by management. Another survey conducted by Hasan Yusuf Dawud in 1996 found that only 39 per cent of appointments were made by shareholders.[1023] Returning to the example of the Islamic Bank of Britain, SSB members there are appointed and suspended directly by directors, so sharia scholars are, in effect, dependent on the firm's management for their continued employment.[1024] They thus have an economic stake in the firm.

In practice conflicts of interest may be mitigated to some extent by sharia scholars' ethical standards and the high cost that would be inflicted upon their reputation and career prospects in the case that their services were deemed to have denigrated the sharia.[1025] However, the risk raises important questions about whether SSBs are in a position to credibly perform their duties to the best of their ability and religious conscience. In assuming the role of vetting Islamic financial products and services for their sharia compatibility, the SSB assumes responsibility for the religious interests of the Muslim consumer/investor.

Another survey conducted by the International Institute of Islamic Thought brought an equally vexing problem to attention. The survey sought to uncover the methods by which sharia

---

[1022] Bakar, "Board" (2002), 78.

[1023] Ibid.

[1024] IBB, "Articles" (2008), 9-10.

[1025] Greuning and Iqbal, *"Risk"* (2008), 189.

scholars came to know of a sharia-relevant problem or issue which required their expertise. A range of responses were submitted. SSBs that had established permanent offices in IFIs and whose duty it was to vet all products and related documentation totalled 10.8 per cent of all respondents. SSBs which conducted periodical meetings to address issues brought forth by the management totalled a staggering 48.5 per cent. Only 6.2 per cent of respondents addressed sharia issues by way of regular audit. Finally, 27.3 per cent described having employed alternative methodologies to undertake sharia-related tasks.[1026] The implication of this survey, if it is to be taken as a general trend, is disturbing. The disproportionate percentage of SSB respondents who come to address issues of sharia-relevance via their firm's management reveals a strong level of dependence upon the availability, amount and quality of information supplied by the management. While there are a number of reasons why a firm's management could fail to disclose sharia-relevant information to its SSB, the circumstances demonstrate the pitfalls of moral hazard that threaten the credibility of the internal audit system.

A related issue concerns the qualifications and skills of sharia supervisory board members and hence the quality and consistency of judgment employed in making sharia-related decisions. Sharia scholars are expected to be knowledgeable in Islamic law as well as financial and accounting practices. Yet, in practice, very few scholars, on a global basis, are considered to possess expertise in all these disciplines.[1027] Moreover, no formalised system of accreditation or professional association has been established so as to provide regulators with the knowledge

---

[1026] Bakar, "Board" (2002), 81.

[1027] Grais and Pellegrini, "Governance" (2006), 20.

and confidence that sharia scholars are competent and capable of fulfilling their auditing and advisory roles, despite IFSB recommendations.[1028] While Malaysia has taken steps to remedy this problem by creating a national sharia advisory council, other countries such as the UK have been very reluctant to do so for reasons that have been examined.[1029] However, the rather low percentage of sharia scholars who are able to combine knowledge of the sharia with financial theory is gradually improving with the introduction of many educational programmes in Islamic finance as well as positive law and conventional finance.[1030] In addition, many IFIs have established in-house sharia training programmes in which young scholars are paired up with senior scholars on a mentoring basis.[1031] The recruitment and training of additional staff with sharia knowledge and financial expertise will contribute significantly to the quality of sharia supervision and will help to dispel conflict of interest issues associated with multiple SSB memberships.

Furthermore, the issue of consistency of sharia legal opinions across IFIs and jurisdictions continues to bedevil the industry, as noted in chapter four concerning the issue of sharia standardisation. Besides limiting the growth prospects of the industry, however, lack of

---

[1028] IFSB, “Guiding Principles” (2006), para 52.

[1029] Wilson, "Regulatory Challenges” (2010), 385. Reasons include the UK government’s unwillingness to involve itself in the process of religious interpretation.

[1030] Bakar, "Board” (2002), 78.

[1031] Shikder, "Islamic Finance” (2009), 31.

consistency undermines consumer confidence in the types of products that have been allowed and in the industry as a whole.[1032]

Another issue concerns the disclosure of all information relating to an IFI's sharia supervisory process. In general, investors are faced with an absence of information relating to the activities of the SSB. Ideally, an IFI would disclose the duties, competence, composition and decision making of the SSB, including the publication of all fatwas.[1033] In practice, the irregular conduct of the internal sharia audit and the non-existent provision of information concerning the SSB's decision making disadvantages the consumer from making optimal investment decisions. Finally, the fatwa concerning the financial product provides no indication of the legal reasoning employed to approve a product. This lack of disclosure discourages confidence in the industry and prevents a larger role for market discipline from taking root.

Once a product has been approved and formally launched, "sharia supervision may take the form of ongoing monitoring through periodic audits. Such audits may be undertaken by means of site visits, document reviews, or consultation with management at regular intervals".[1034] In practice, however, the *ex post* verification of transactions has received much less attention from SSBs. In fact, most IFIs do not undertake the *ex post* verification of transactions for their sharia-

---

[1032] Grais and Pellegrini, "Governance" (2006), 20-21.

[1033] Greuning and Iqbal, "Banking" (2007), 36.

[1034] DeLorenzo, "Supervision" (2009).

compliance.[1035] Recall that this issue was recently highlighted (see section 5.4) in the 2008 AAOIFI statement concerning the failure of IFIs to properly monitor the transaction of IF products and services.

In the next section the FSA's approach to regulating sharia supervisory boards is considered.

8.4 THE RISKS OF SHARIA NON-COMPLIANCE

Recall from chapter six that the government utilises neutral language in implementing Islamic financial transactions in the UK. This approach reflects the government's unease in transgressing the social understanding regarding the particular role of religion in the UK. In line with this approach the government takes no responsibility for problems of choice of evaluative criteria such as whether an Islamic financial product or service complies with the sharia as it states that this would be "inappropriate" as a "secular" regulator.[1036] Individual financial institutions are wholly responsible for determining the sharia compliance of the products and services they offer. In accordance with AAOIFI standards, most Islamic financial institutions opt to form an SSB comprising three sharia scholars trained in classical Islamic commercial law, although others have chosen to use sharia consultancy services or have merely hired a single sharia scholar. The state does not stipulate any requirement regarding sharia compliance or enforcement with respect to the myriad functions of Islamic financial intermediation. The

---

[1035] Singh, "Shariah Audit" (2009).

[1036] Treasury, "Development" (2008), 19.

Financial Services Authority (FSA) states that "it would not be appropriate, even if it were possible, for the FSA to judge between different interpretations of sharia law".[1037] Hence the FSA believes that neutrality can be achieved by avoiding any subjectivity or "bias" and by focusing on concrete data which can be understood in absolute terms and free of context. Moreover, a neutral position can be claimed between and vis-à-vis faith-based arguments.[1038]

However, the accommodation of the unique role of sharia scholars within IFIs is acknowledged by the FSA as having potential implications for the solvency of Islamic financial institutions. In particular, the market's response to a breach of sharia rules could dispel confidence in IFIs, as compromised assets would automatically be seen as liabilities and a bank's solvency could be thrown into question.[1039] As IFIs become more systemically important and more closely connected with conventional banks, this risk increases,[1040] particularly for wholesale institutions.

While such a scenario has not yet taken place in the UK, anecdotal evidence suggests that British Muslims' low take-up of retail Islamic financial products is related to their highly sceptical opinion concerning the sharia-authenticity of Islamic financial products.[1041] Furthermore, overseas investments from Gulf state investors are probably even more dependent upon the industry gaining the trust and confidence of investors in the sharia authenticity of their products.

[1037] Ainley et al., "Islamic Finance" (2007), 13.

[1038] Malik, "Faith" (2000), 138-39.

[1039] Ainley et al., "Islamic Finance" (2007), 18-19.

[1040] Sole, "Introducing" (2010), 126.

[1041] MCB, "Consultation" (2008), 5.

The British investment bank, Kleinwort Benson, in its first stab at creating an Islamic unit trust in 1986, was not very successful, in part as a result of not employing a sharia supervisory board or even a single sharia advisor to monitor the fund. It had not established the necessary credibility with Gulf investors.[1042] Yet the FSA's approach to regulating IFIs places all its emphasis upon evaluating and mitigating the financial risk that institutions may present, and largely ignores the "religious risk" associated with the development of the industry.

The FSA has acknowledged the unique role of sharia supervisory boards in Islamic financial institutions since these entities are responsible for approving and legitimating the "Islamic" products and services that originate from such institutions. Yet the state is essentially hamstrung from developing criteria and procedures to address the qualitative nature of the boards other than those employed to examine the corporate governance of conventional financial institutions. The FSA's emphasis centres on the role of the SSB in each authorised firm; particularly, the SSB's impact on the direction or operation of the firm. This is partly undertaken by reviewing the terms and conditions of sharia scholars' contracts.[1043] The FSA must determine whether sharia scholars are assigned an executive role or whether they merely provide advisory services to the institution. According to the FSA Approved Persons rules,[1044] the suitability of anyone acting as a director is assessed according to "fit and proper" criteria. For example, these criteria relate to the competence and capability of the candidate, so a

---

[1042] Wilson, "Challenges and Opportunities" (2010), 370.

[1043] Ainley et al., "Islamic Finance" (2007), 14.

[1044] FSA, "Fit and Proper" (2011).

prospective director would be expected to have relevant experience and education. If a sharia scholar's role does resemble that of an executive director, multiple memberships of different financial institutions' SSBs would be problematic due to significant conflicts of interest. We have seen on an international basis that the practice of sharia scholars sitting on multiple supervisory boards is a common, if not regular, occurrence. However, FSA-authorised IFIs to date have shown that sharia scholars occupy advisory roles so that their responsibilities do not interfere in the management of the firm.[1045] However, this finding is unconvincing. The SSB's objective, to ensure the "sharia compliance in all an entity's products and transactions",[1046] plays a pivotal role in the organisation; indeed, the SSB's existence legitimises the Islamic label and constitutes an important motivation in Muslim consumers' demand for Islamic financial products and services. It seems unlikely that those individuals who decide whether a product can be brought to market under the Islamic brand do not have an impact on the management of the firm.

The FSA attempts to justify its inattention to the religious risks associated with sharia supervisory committees by requiring that Islamic financial institutions "pay due regard to the interests of its customers and treat them fairly".[1047] The FSA's Treating Customers Fairly (TCF) programme lays emphasis on the provision of clear information, suitable advice and an acceptable level service".[1048] However, these requirements do not oblige the FSA or the IFI to provide information on whether particular products are sharia-compliant. The FSA does require

---

[1045] Ibid.

[1046] Ibid., 15.

[1047] Ibid., 24.

[1048] Ibid.

IFIs to provide an explanation of Islamic financial products and their associated risks,[1049] but this information concerns the economic risks of products; it takes no notice of any qualitative attributes. For example, the government has made an effort to distribute fact-sheets on Islamic home mortgage purchase plans (known as HPPs) which provide a "step-by-step guide to each product and the associated risks and benefits".[1050] This information is not sufficient to determine whether such products comply with Islamic law.

Finally, issues concerning financial malfeasance and false advertising need to be considered. In particular, the Consumer Protection from Unfair Trading Regulations 2008[1051] reinforces other consumer protection acts including the Trade Descriptions Act 1968[1052] and the Fraud Act 2006.[1053] In general, this legislation makes illegal "misleading actions" based upon false information as to the nature or main characteristics of the product or service; and actions which cause or are "likely to cause the average consumer to take a transactional decision he would not have taken otherwise".[1054] Yet an offence can only be established under the regulations if it can be proven that the service provider knowingly or recklessly engaged in a misleading action.[1055] Hence, as there is neither an agreed standard on what constitutes sharia compliance

---

[1049] Ibid., 25.

[1050] Ibid.

[1051] "Consumer Protection", SI 2008/1277.

[1052] Trade Descriptions Act 1968.

[1053] Fraud Act 2006.

[1054] "Consumer Protection", pt 2, s 5(2)(b).

[1055] MCB, "Consultation" (2008), 11-12.

nor enforcement other than the non-binding standard-setting efforts of international organisations such as AAOIFI, claims of false advertising are generally non-justiciable.

CONCLUDING REMARKS

Islamic financial intermediation is based on a profit-and loss-sharing model in which profits are shared in agreed ratios and any losses are passed on to the investor/depositor pursuant to the *muḍārabah* contract. Theoretically, under the two-tier *muḍārabah* model, IFIs are not liable for any losses except their time and effort in managing the investment on behalf of depositors. In practice, Islamic banks prefer debt-based contracts such as *Murābaḥah*, *istiṣnā'* and *salam* that produce short-term profits and are relatively liquid. These types of financing structures constitute approximately 80 per cent of a typical IFI's balance sheet.

Profit- and loss-sharing modes of finance are associated with a number of additional risks that conventional retail banks usually do not countenance. These risks are associated with the moral hazard occasioned by the *muḍārib's* investment activities and the limited oversight available to the Islamic bank in accordance with the law pertaining to the *muḍārabah* contract. Other principal-agent risks associated with the terms and conditions of the *muḍārabah* are asymmetric risk, fiduciary risk, adverse selection, and displaced commercial risk. Furthermore, investors are exposed to the uncertainty of different accounting treatments of investment accounts that make financial comparability across jurisdictions extremely difficult. In the UK, IFRS standards are required of IFIs, so this is less of a concern.

The UK domestic industry has faced several regulatory difficulties as a result of the hybrid legal structure associated with Islamic financial contracts. These include questions of how to categorise Islamic financial contracts according to the FSMA 2000 Regulated Activities Order. Another serious challenge involves the statutory definition of a deposit and its capital guarantee requirement. This law effectively prevents Islamic banks from using the *muḍārabah* on the liabilities side of the balance sheet. The result is that the PLS model – the cornerstone of Islamic finance – is not a feasible model in the UK. However, there is reason to believe that British Muslims, and indeed most Muslim investors around the world, have not shown a definite preference for profit-and loss-sharing modes of finance. Arguably, Muslim consumers/investors have internalised the conveniences of modern finance and consumer lifestyles, and enjoy the certainty and predictability that capital-guaranteed investment accounts afford.

The sharia audit process of SSBs differs according to IFIs' articles of association. In practice, very few national regulators take part in the composition, procedures or any other aspect of SSB functions. Most IFIs have adopted AAOIFI standards concerning the sharia audit process, which includes regular audits, site visits, document reviews and advisory work concerning the development of products.

Several problems affect the integrity of SSB governance and thus undermine confidence in the industry. These problems relate to sharia scholars' independence, confidentiality, and competence in their positions as sharia advisors to financial institutions. Issues also concern

SSB's consistency across jurisdictions and information disclosure policies. Surveys of SSB practices from a large number of IFIs indicate that these problems are widespread and deep-seated.

The FSA's regulatory approach toward Islamic finance is designed to facilitate a level playing field that enables Muslims to practice finance in accordance with their faith. The FSA does not show favouritism towards Islamic finance or any other mode of finance. Nor does it believe that it would be appropriate to intervene in the religious functions of Islamic financial institutions. Therefore, the authority does not interfere with any aspect of the sharia law-making capacity of sharia supervisory committees – which most Islamic financial institutions house – other than to enforce the Approved Persons regime of the FSMA 2000. Accordingly, the FSA has categorised sharia scholars as non-executive persons, which provides that they are not involved in the management of the financial institution. This assessment takes no cognisance of the religious risks associated with sharia non-compliance. Conventional regulatory authorities are ill-equipped to deal with IFIs' religious functions by virtue of the appropriate role of the state in religious matters in the United Kingdom.

The following chapter is the last substantive research chapter of the thesis. It examines the final piece in the complex web of law that constitutes the UK Law of Islamic Finance; namely, the enforcement of Islamic financial transactions in English courts.

CHAPTER NINE: THE ENFORCEMENT OF ISLAMIC FINANCIAL TRANSACTIONS

INTRODUCTION

This chapter is concerned with the enforcement of Islamic financial transactions in English courts and with the implications of enforcement for the industry. In particular, the chapter demonstrates the legal challenges that prevent Islamic financial transactions from being enforced according to the sharia. Moreover, arbitration as an alternative means of dispute resolution for Islamic financial transactions is considered. Finally, the chapter illustrates the pluralistic legal interaction that the enforcement of Islamic financial transactions brings about and the difficulties that it presents.

This topic is addressed by analyzing first several recent cases in the English courts. In the second half of the chapter the role of arbitration is the focus; in particular, its feasibility in cross-border commercial transactions and its compatibility with attitudes in the Middle East are considered. Finally, specific cases in which arbitral awards have been adjudicated in English courts are examined.

9.1 ISLAMIC FINANCIAL TRANSACTIONS IN ENGLISH COURTS

Parties to international commercial and financial transactions often adopt English law as the governing law of their contract due to its "well-known and well-developed jurisprudence [...] which is not open to doubt or disputation on the basis of religious or philosophical principle".[1056] In particular, freedom of contract in English law has proved pivotal to English law's international success. It represents a laissez faire approach that views the "courts' role as that of enforcing parties' bargains" so long as they do not transgress acceptable norms of behaviour.[1057] Freedom of contract in English law has helped to create some of the most efficient and flexible financial markets in the world; as well as a regime for security interests "which is unrivalled for its informality and its willingness to allow the parties to define their own rights and remedies and to organise their relationships in whatever way they consider best suited to their needs".[1058] Furthermore, The English courts have a strong reputation for impartiality and competence, and the English legal profession has a high reputation for their specialist international commercial expertise. Both domestic and international traders have come to associate English law with the stability and predictability that is necessary for international commerce to flourish.[1059]

Only a handful of published court decisions involving Islamic financial transactions have been reported worldwide. Malaysia is one jurisdiction in which some published case law exists.

[1056] *Shamil Bank v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19 [54].

[1057] Goode, "*Millenium"* (1998), 31.

[1058] Ibid.

[1059] Ibid.

Many Middle Eastern jurisdictions, however, do not report their case law and private law firms are not disposed to report cases in which they have acted as counsel. Bälz indicates that plain vanilla financial transactions have generally become non-litigious; and that financial institutions are wary of creating innovative structures that expose them to lawsuits.[1060] In fact, most financial transactions are settled out of court. All of these factors may have contributed to a scarcity of case law.

9.1.1 THE SYMPHONY GEMS CASE

Islamic Investment Co Ltd v Symphony Gems NV[1061] (Symphony Gems case) is reportedly the first Islamic financial transaction decided in a Western court.[1062] The case involved a *murābaḥah* financing agreement made between the parties "in accordance with the Islamic Shariah" that was nonetheless governed by and construed according to English law.[1063] Further, the importance of the case resides in its illustration of the way in which English courts uphold parties' contractual agreements where these are not constrained by the rules of mandatory legal provisions or public policy. The case also demonstrates the mixed nature of the Law of Islamic Finance. Specifically, it shows the interaction of the sharia, English law and

---

[1060] Bälz, "Murabaha" (2004), 118-19.

[1061] [2002] Transcript.

[1062] Moghul and Ahmed, "Contractual Forms" (2003-2004), 155.

[1063] *Symphony Gems* (n 1063) (A).

the law of the Bahamas, together with internationally recognised commercial principles when these are enforced in an English court of law.

The Islamic Investment Company ((IIC) the claimant) and Symphony Gems ((SG) the first defendant; the second and third defendants served as guarantors) made an agreement involving a "revolving sale and purchase facility". The seller (IIC) granted the purchaser (SG) the facility. The seller agreed to purchase rough diamonds from a supplier and immediately sell these to SG on deferred payment terms pursuant to purchase agreements. Two purchase agreements were made, each to equal $7,500,000 in rough diamonds. According to the purchase agreements, IIC transferred $15 million to the account of Precious Ltd, based in Hong Kong and was to receive $7,917,450 in payment for each advance. However, IIC did not receive payment and sought to retrieve these monies, accrued interest and damages, minus $7.5 million recovered pursuant to a bank guarantee.[1064]

The case turned on the defence's claim that the outstanding balance required delivery of the rough diamonds to the purchaser, i.e. whether the sale price is due in the absence of delivery. Tomlinson J took note of the fact that the defendants did not raise the issue of absence of delivery to the claimants prior to the proceedings, a fact that assisted the Tomlinson J in reaching his conclusion.[1065] A purchase agreement "means an agreement made between the Purchaser and the Seller for the purchase of Supplies by the Seller from the relevant Supplier

---

[1064] Ibid.

[1065] Ibid.

and for the sale of those Supplies by the Seller to the Purchaser [...]".[1066] Pursuant to clause 4.3, those purchase agreements required the purchaser "to enter into arrangements with the supplier to the effect that the seller will purchase the supplies from the supplier", or else the agreement would be automatically terminated.[1067] On this basis, Tomlinson J concluded that "all of the arrangements concerning the acquisition of goods by the seller from the supplier fall to be made by the purchaser, for the very good reason that this is a financing agreement facilitating or apparently facilitating the purchase of supplies by the purchaser".[1068] Furthermore, "if therefore there has been no delivery of goods from the supplier to the seller and thus from the seller to the purchaser, that can only be because the purchaser has not made the necessary arrangements".[1069]

Further, clause 4.4 provides that "the instalments are payable whether or not the seller is in breach of any of its obligations under the relevant purchase agreement" and this would certainly include a failure to deliver.[1070] Payment was to be made unconditional of any event. Nowhere in the agreements was a delivery date specified nor were any procedures provided for the logistics of such arrangements. Hence, Tomlinson J ruled that the delivery of goods was "not a

---

[1066] Ibid., cl 3.

[1067] Ibid., cl 4.3.

[1068] Ibid., cl 4.4, 5.1, 5.2, 5.6.

[1069] Ibid.

[1070] Ibid., cl 4.4.

prerequisite to recovery by the sellers of the relevant instalments of the sale price from the purchaser". [1071]

In *Symphony Gems* the legal issue concerning the Islamic legal definition of a *murābaḥah* contract[1072] was not a concern of the court, because the issues on which the court was to decide were strictly matters of English law. Clause 25 of the agreement clearly stated: "This Agreement and each Purchase Agreement shall be governed by, and shall be construed in accordance with, English law."[1073] Morrison J concluded that he "must simply construe it according to its terms as an English law contract."[1074]

The defence also claimed that the contract was illegal, a claim dependant on the court's construction of the contract being found unlawful in the place of performance. The defence claimed that the contract envisaged performance in Saudi Arabia. In that case the sharia would be applicable to the transaction and its terms and conditions would likely be void. Tomlinson J did not find that the contract called for performance in Saudi Arabia and therefore ruled that the principle of illegality was irrelevant.[1075]

[1071] Ibid.

[1072] Evidence provided by Dr Yahya Al-Samaan, partner of the law firm Salah Al-Hejailan in Saudi Arabia and Dr Martin Lau, then Lecturer in South Asian law at the School of Oriental and African Studies, indicated that the transaction did not meet the requirements of the classical *murābaḥah*.

[1073] Ibid., cl 25.

[1074] Ibid.

[1075] Ibid., .

The next argument relied upon by the defence was an *ultra vires* argument. *Ultra vires* is a 19th century doctrine that limited a company's legal capacity to the objects stated in its memorandum of association. Any action which transgressed those limits was in principle void.[1076] With respect to this particular contract the defendant claimed that the "contract is outwith the objects stated in the Claimant's Memorandum of Association, which includes the limitation to carry out in a manner which is consistent with Islamic laws, rules, principles and traditions the following objects".[1077] Referring to the expert testimony provided by Dr Yahya Al-Samaan, Tomlinson J agreed that the essential characteristics of the *murābaḥah* had not been met in this transaction. Yet the application of the *ultra vires* doctrine depended on the law of the Bahamas, the jurisdiction in which IIC was incorporated, because the capacity of corporate entities is determined by the place of incorporation rather than the governing law of the contract. Tomlinson J ruled that Bahamian law it did not prevent the IIC from acting outwith its objects, so *ultra vires* could not be relied upon by the defence.

In *Symphomy Gems* Tomlinson J's judgment for the claimant highlights an English tradition of freeing the hands of commercial parties and thus upholding the bedrock doctrine of party autonomy. The court's primary concern was in upholding a properly agreed contract and thus safeguarding commercial interests. This represents a historical continuity of English courts upholding reasonable business practices where these are not otherwise constrained by the

---

[1076] Davies, "*Company Law*" (2008), 153.

[1077] *Symphony Gems* (n 1063).

rules of mandatory legal provisions or public policy. As a result, the business community is granted wide discretion to agree the terms of contracts.[1078]

The following section addresses a very influential case in which the question of whether the sharia can be chosen as the governing law of the contract was debated.

9.1.2 THE BEXIMCO CASE AND THE ROME CONVENTION

Shamil Bank v. Beximco Pharmaceuticals Ltd (the Beximco Case) was an appeal from the High Court, in which Morrison J found in favour of the respondent, Shamil Bank of Bahrain, and made an award of US $49.7 million. Appeal to the Court of Appeal was granted on a single point "in relation to the construction and effect of the form of the governing law clause contained in the financing agreements".[1079] The clause in question reads: "Subject to the principles of the Glorious *Sharia'a*, this Agreement shall be governed by and construed in accordance with the laws of England".[1080]

The Court of Appeal's ruling illustrates two key principles. First, the Rome Convention on the Law Applicable to Contractual Obligations[1081] – an EU treaty whose provisions, in general,

---

[1078] Bälz, "Murabaha" (2004), 126.

[1079] *Beximco* (n 1058) [1].

[1080] Ibid.

[1081] European Convention 80/934/ECC on the Law Applicable to Contractual Obligations (Rome Convention) [1980] OJ L266/1.

established the law governing contractual relations in the UK at the time in which the case was heard – made clear that a contract could only be governed by the law of a country so that a contract which sought to incorporate a non-state law or body of principles such as the *lex mercatoria* or the sharia would not be recognised as the applicable law of a contract.[1082]

Second, the judgment demonstrates the relevant application of the English doctrine of incorporation, in which parties may incorporate specific 'black letter' terms of a foreign law or general legal principles or non-state law into an English contract but which can only serve as a source of law from which the governing law may draw. 'Incorporation' is a shorthand method of including a limited set of terms so as to avoid laying out the articles of a foreign law in full. The court would construe an English contract, "reading into it as if they were written into it the words" of the foreign law.[1083] In such a case where there existed ambiguity or doubt as to the effect of such rules, the court would rely upon the testimony of experts in foreign law.[1084] However, the courts are not bound to the expert evidence on foreign law inasmuch as they are "interpreting the terms of an English contract and not applying foreign law," as established under the authority of *Stafford Allen & Sons Ltd v Pacific Steam Navigation Co.*[1085]

[1082] Ibid., [48]; Collins, "*Conflicts of Laws"* (2006), 1568. A subsequent EU Regulation on the law applicable to contractual obligations, known as Rome I, now supersedes the Rome Convention in all EU member states. See Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) [2008] OJ L177/6.

[1083] Collins, "*Conflicts of Laws"* (2006), 1571.

[1084] *Halpern v Halpern* [2007] EWCA Civ 291 [31].

[1085] [1956] 2 All ER 716. Collins,"*Conflicts of Laws"* (2006), 1572.

The background of the case centred on the Beximco Group's efforts to seek working capital from the respondent, Shamil Bank – an IFI – whereby monies were advanced via two "*morabaha* financing agreements".[1086] A principal *murābaḥah* financing agreement was entered into between the first defendant, the second defendants and the bank, under which the bank agreed to purchase, with the second defendant acting as its agent, certain goods to be sold to the first defendant.[1087] Pursuant to the initial 1995 *murābaḥah* agreement, Shamil Bank advanced the second defendant US$15 million. In 1996 a second *murābaḥah* agreement was agreed and another US$15 million was advanced for the purchase of specified goods. By December 1999 the defendants had defaulted on the agreements.

Subsequent negotiations led the bank and the first and second defendants to enter into two Exchange in Satisfaction and User Agreements (ESUA) modelled on an *ijārah* contract, with the third, fourth and fifth defendants acting as guarantors. The ESUAs provided that the bank would discharge the amounts outstanding under the 1995 and 1996 *Morabaha* agreements in exchange for unencumbered title to certain assets. The defendants were entitled to use those assets in the normal course of their business "in consideration for payment by instalments of a user fee" as well as other "payments of accrued compensation".[1088] Subsequently, termination and default events occurred and Shamil initiated proceedings in the English court.[1089]

[1086] *Beximco* (n 1058) [12].

[1087] Ibid., 14.

[1088] Ibid., [19]-[20].

[1089] Ibid., [20]-[21].

The appellants did not dispute the fact that there can be only one governing law in respect of the agreements, nor that the proper law of these agreements was English law. Article 1.1 of the Rome Convention requires the parties to choose the law of a country to govern their contract.[1090] It stipulates that "the rules of this Convention shall apply to contractual obligation in any situation involving a choice between the laws of different countries".[1091] On the face of it Article 1.1 is not "applicable to a choice between the law of a country and a non-national system of law, such as the lex mercatoria, or "general principles of law", or as in this case, the law of *Sharia*". Article 3.1 of the Rome Convention, which provides that "a contract shall be governed by the law chosen by the parties" and with reference to choice of a "foreign law" in conjunction with Article 3.3, "make it clear that the Convention as a whole only contemplates and sanctions the choice of the law of a country".[1092]

Yet the appellants contended that the financing agreements were only enforceable in the event that both the sharia and English law were complied with.[1093] The principles of the sharia should be given relevance.[1094] Further, it was argued that the construction of the governing law "produces a result no different from the incorporation by reference of a codified system of rules,

---

[1090] Rome Convention [1980]. Article 3.1 of the Rome Convention was implemented in the UK under article 3, paragraph 1 of the Contracts (Applicable Law) Act 1990 and applied to all contracts made after 1 April 1991. See *Contracts (Applicable Law) Act 1990*.

[1091] Rome Convention [1980], art 1.1.

[1092] *Beximco* (n 1058) [48]. For analysis of this case see Bälz, "Rome Convention", 45; Chuah, "Morabaha" (2006-2007), 168; DeLorenzo and McMillen, "Law" (2007), 162; Junius, "Islamic Finance" (2007), 537.

[1093] *Beximco* (n 1058) [27], [42]; [2003] EWHC 2118 [15].

[1094] *Beximco* (n 1058) [42].

such as the Hague Rules or the Warsaw Convention into a contract governed by English law [...]".[1095] For example, the Court of Appeal in *Nea Agrex SA v Baltic Shipping Co Ltd*[1096] rejected a lower court's conclusion that a "paramount clause provision was to be treated as ineffective to incorporate the Hague Rules into a charterparty".[1097] In that case the Court of Appeal held that the court should strive to give meaning to an incorporated clause if at all possible, rather than rendering it meaningless.[1098] Hence the defence argued specifically that the rules relating to interest and the nature of the *murābaḥah* and *ijārah* agreements should be read into the agreement in accordance with the "principles of the Glorious *Sharia*" governing clause.[1099]

However, the court ruled that the doctrine of incorporation can only function where the parties have identified the terms of their contract in "specific 'black letter' provisions of a foreign law", international code, or set of other rules such as the Hague rules, which are amenable to incorporation as "terms" of the relevant contract. The doctrine enables parties to an English contract to agree a contract which is construed in accordance with the relevant articles of a foreign law or non-state law. The effect of such would not make a non-state or foreign law the governing law of the contract, rather the specific articles of such a law would be incorporated as contractual terms into an English contract.[1100]

[1095] Ibid., [43].

[1096] *Nea Agrex SA v Baltic Shipping Co Ltd*, [1974 N. No. 2011] - [1976] Q.B. 933.

[1097] *Beximco* (n 1058) [43].

[1098] *Nea Agrex* (n 1098), 935.

[1099] *Beximco* (n 1058) [49].

[1100] Collins, "*Conflicts of Laws"* (2006), 1571.

Unlike *Nea Agrex*, in the present case "the general reference to the principles of the sharia [...] affords no reference to, or identification of, those aspects of sharia law which are intended to be incorporated into the contract, let alone the terms in which they are framed".[1101] Thus the court agreed with the general consensus amongst experts that the reference to the sharia does not afford the court with a direct reference to specific terms or other legal rules intended to be incorporated into the contract.[1102] This prevented the court – even if the court was able to do so – from determining the dispute according to such religious principles.[1103] However, if specific provisions of the sharia had been included in the parties' agreements with respect to *ribā* and the contractual essentials of the *murābaḥah* and *ijārah*, the "defendants would have been likely to succeed".[1104]

The UK government's decision to opt-into the Rome I Regulation – note that Rome I is a regulation and is thus directly effective in English law – has allowed the successor to the Rome Convention to be applied to contracts concluded after 17 December 2009.[1105] Like the Rome Convention, the principle of party autonomy in relation to parties' choice of law is "substantively the same" as in Rome I.[1106] Like the convention the regulation does not foresee parties' choice

---

[1101] *Beximco* (n 1058) [52].

[1102] Ibid., [55].

[1103] Chuah, "Morabaha" (2006-2007), 151; *Beximco* (n 1058) [40].

[1104] Ibid., [55].

[1105] News, "Rome I" (2008).

[1106] Justice, "Rome I" (2008), para 45.

of a non-state body of law as the choice of law despite an early draft resolution which might have permitted parties to choose public international law.[1107] The final session of regulation does offer parties the means to "incorporate" non-state law or international standards by reference into their contract,[1108] for recital 13 of the Preamble to Rome I provides that the regulation "does not preclude parties from incorporating by reference into their contract a non-state body of law or an international convention".[1109] However, this leaves unresolved the problems of convincing an English court, in the light of the Beximco decision, that the sharia is a "body of law" which can be incorporated.[1110]

Some observers have perceived this as a slight to Islamic jurisprudence and a relegation to second-class status.[1111] Some Muslims have taken offence at Morrison J's comments in *Beximco* to the effect that the sharia was unfit to govern modern commercial or banking transactions on the basis that its provisions are difficult to specify or ascertain. They view this as a '*capitis deminutio*', a diminution of the sharia and contextualise the court's findings in the light of early arbitration awards such as *Sheikh Abu Dhabi v. Petroleum Ltd*,[1112] *Ruler of Qatar v. International Marine Oil Company Ltd,*[1113] and the well known 1958 *Aramco v. Government of*

[1107] Wood, "*Conflict of Laws"* (2007), 62.

[1108] Rome I [2008], para 13.

[1109] Ibid.

[1110] Following discussions with NHD Foster.

[1111] Chuah, "Morabaha" (2006-2007), 168.

[1112] [1953] 47 AJIL 156.

[1113] [1953] 20 Int LR 534.

Saudi Arabia[1114] award. In each of these cases, British judges held that the sharia could not "reasonably be said to exist", or it "contains no precise rule" concerning a particular contract, so that Islamic law could not "reasonably" be used as the governing law.[1115] Furthermore, they assert that many legal systems entail similar difficulties, and that the law of the land in Saudi Arabia is the sharia. Moreover, the sharia is an internationally recognised body of law. The International Court of Justice recognises the sharia as belonging to the general principles of law recognised by civilised states.[1116] Why then should the problem of ascertaining the law arise, when, in fact, it is applied in international commercial arbitrations?[1117]

An important consequence of the *Beximco* case concerns the religious risks which arise from non-compliance with the sharia. Potter LJ remarked that neither party "was under any illusion" as to the true nature of the transactions which provided long-term working capital and that both parties "were content to dress the loan transactions up as *morabaha* sales (or *ijārah* leases), whilst taking no interest in whether the proper formalities of such a sale or lease were actually complied with".[1118] Accordingly, Potter LJ felt that the dispute should be approached in accordance with the actual substance of the agreement rather than construing the wording in a manner which would be irreconcilable with the authors' intentions.[1119] Furthermore, the effect of

---

[1114] [1958] 27 Int LR 117.

[1115] Fadlallah, "Arbitration" (2009), 307-08.

[1116] Ballantyne, "Shari'a" (2010), 11.

[1117] Examples of arbitration in which parties have chosen the sharia as the substantive law of their agreement are considered in the following section.

[1118] *Beximco* (n 1058) [47].

[1119] Ibid.

the *Beximco* judgment in City law firms has been to reduce the sharia aspect of deals to a matter of compliance and not law.[1120] These considerations may unsettle the market since the court indirectly determined that the types of *murābaḥah* and *ijārah* transactions performed in the case at hand did not comply with a strict interpretation of the sharia. As a result, the court intimated that a genuine link between the subject matter and the financing must be made for these contracts to fulfil their Islamic criteria. Hence, the Court of Appeal has indirectly defined the "authentic" version of these transactions as sale-based transactions. In doing so, issues of liability and mandatory policy as discussed above could limit the flexibility and use of these types of instruments.[1121]

Beximco also illustrates the importance of the industry's standardisation efforts. Specifically, the sharia will not be applied in an English court of law unless it can be convinced that an authoritative interpretation of the sharia can be determined. AAOIFI standardisation efforts are an important step in this process and yet the willingness of financial institutions and affected countries to implement these rules has been ad hoc and minimal. The lack of convergence around such standards or of another set of authoritative standards prevents parties from making a more general contractual reference to 'the agreed standards of Islamic commercial law;' but it may enable parties to incorporate specific AAOIFI rules as long as these are clearly indicated. Second, the judgment must necessarily refocus the industry's attention on the important work of sharia supervisory boards' audit and assessment of IFI's products and transactions. English

---

[1120] This information was communicated to me in person by NHD Foster.

[1121] Chuah, "Morabaha" (2006-2007), 149.

courts have made it very clear that they will not play the role of SSBs in determining the sharia compliance of financial transactions. Hence, the judgment is a very important marker for IFIs in terms of their legal expectations. The burden of ascertaining the Islamicity of products lies in the preparation of contracts and internal sharia audit systems and controls.[1122]

9.1.3 THE INVESTMENT DAR CASE[1123]

The Investment Dar Company KSCC (incorporated in Kuwait – TID) and Blom Developments Bank SAL (Blom) entered into a *wakālah* (agency) agreement pursuant to which Blom made several deposits. Blom's prinicipal investments as well as an anticipated profit return were guaranteed, equivalent to a loan-bearing investment.[1124] TID's SSB approved the sharia compliance of the agreement in October 2007.[1125]

Blom claimed sums allegedly due under the agreement and applied for summary judgment. Summary judgment, a legal device to expeditiously dispose of a case without a trial, is used

---

[1122] Junius, "Islamic Finance" (2007), 542. Some arguments have been advanced that *Uddin v Choudhury* [2009] EWCA Civ 1205 has overturned the persuasive precedent set by the Court of Appeal in *Beximco*. However, from this author's standpoint, *Uddin v Choudhury*, a matrimonial dispute, is not relevant to the *Beximco decision*. This is supported by the absence of any mention of Rome I or the *Beximco* judgment. An unpersuasive argument was made in Bowen, "English Courts" (2010).

[1123] *The Investment Dar Company KSCC v Blom Developments Bank SAL* [2009] EWHC 3545(Ch) [12].

[1124] Ibid., [2].

[1125] Ibid., [10]. See also Cunningham, "Sharia Boards" (2010).

when there is no dispute concerning the material facts of the case, and a party is entitled to judgment as a matter of law. Blom claimed in contract and trust.

TID's memorandum of association requires that all transactions are sharia-compliant.[1126] Nonetheless, TID argued that the agreement was not sharia-compliant, was therefore ultra vires its memo and void under Kuwaiti law. A court's ruling that a contract had been undertaken *ultra vires* its articles of association would be deemed void despite any recitals, contractual representations and promises not to challenge the sharia-compliance of the agreement, which was provided in the master *wakālah* agreement.[1127]

At the summary judgment hearing, Master Bragge found that this was triable issue but found for Blom with respect to its trust claim.[1128]

However, Purle J ruled that the trust claim 'was sufficiently arguable […] that there is no trust claim', and so decided it was a triable issue.[1129] Furthermore, Purle J agreed with Master Bragge, that the ultra vires claim was also a triable issue.[1130]

[1126] Ibid., [3], [4].

[1127] Norton Rose, "Implications" (2010).

[1128] Ibid., [18].

[1129] Ibid., [19]-[20].

[1130] Ibid., [20].

The Investment Dar caused much consternation in Islamic financial markets as a result of the sharia compliance risks the case highlights.[1131] Yet the case has no precedential value; it is merely an appeal from summary judgment. Furthermore, there is nothing out of the ordinary about the court's decision. It was simply that the *ultra vires* issue was triable. The case has not been to trial and the issue has not been argued, so we do not know what the result would have been (e.g. there might not have been a problem under Kuwaiti law). Furthermore, *ultra vires* is a well-known issue and the possibility of its occurrence is a matter of standard due diligence. Finally, the case is disquieting in that an IFI should have produced such an argument, but it remains highly unusual.

The following section examines alternative methods of dispute resolution available to Islamic financial transactions.

9.2 ARBITRATION AND ISLAMIC FINANCIAL TRANSACTIONS

Arbitration allows contracting parties to an Islamic financial transaction the possibility of choosing a non-state body of law or other legal principles as the applicable law of their contract. Theoretically, contracts in which the sharia, the *lex mercatoria* or the general principles of law are the express choice of the parties will be given effect in most jurisdictions around the world. As long as parties have agreed that such rules apply or in circumstances in which the parties

---

[1131] CityUK, "Islamic Finance" (2011).

have remained silent concerning the governing law, the choice of a non-state law will not affect the validity or enforceability of the arbitral award.[1132]

However, in practice, the utility of arbitration in most Arab jurisdictions is limited to some extent by the uncertainty of whether foreign arbitral awards will be enforced. Furthermore, banks and financial institutions have shown an antipathy towards arbitration for a number of reasons examined below.

9.2.1 THE PROS AND CONS OF ARBITRATION

Arbitration is a process in which parties who are in dispute have agreed, either in their contract or after a dispute has arisen, to submit their dispute to an experienced person who they believe will exercise good judgment and impartiality in resolving their conflict. This person or persons decide the dispute according to the procedures or law of a private tribunal known as the *lex arbitri*. The substantive matters of the dispute may be governed by an entirely different law, or the *lex arbitri* may also be chosen as the law in this instance. However, most international arbitrations are carried out in a neutral country – a country in which the parties are not habitually resident – and the law which governs the enforcement of the award is almost always different from the law chosen to regulate the arbitration proceedings. The arbitrator's decision is both final and binding on the parties because the parties have agreed to bind themselves to the

---

[1132] Redfern et al., "*Arbitration"* (2009), 221.

tribunal's decision.[1133] In effect, the choice to arbitrate is to rescind one's "right of recourse to the courts of law in respect of any such dispute".[1134] Arbitration is made internationally enforceable through the New York Convention and the national laws that implement such agreements. The key characteristics of arbitration, the neutrality and competence of the arbitral forum, necessarily require broad international recognition and enforcement of arbitral awards to make the system workable.

The relevance of arbitration to solving commercial disputes is shown by the fact that "international arbitration has become the principal method of resolving disputes between states, individuals, and corporations in almost every aspect of international trade, commerce and investment".[1135] In such disputes huge amounts of money are often at stake. In fact, instances in which large sums are at stake are more likely to be referred to arbitration.[1136] It has been commonly used to decide commercial disputes in a much more flexible manner than court proceedings; and has been noted for its capacity to limit the damage or embarrassment of contracting parties in a manner conducive to future constructive business relations.[1137] Moreover, a major survey found that corporate counsel preferred arbitration over transnational litigation because it offers a "private and independent system, largely free from external

---

[1133] Ibid., 1-9.

[1134] Ibid., 17.

[1135] Ibid., 1.

[1136] PriceWaterhouseCoopers and Queen Mary, "Arbitration" (2008), 3.

[1137] Blackett, "Courts" (2009), 12.

interference",[1138] a reference to the danger of settling commercial disputes when one party is a state.

Furthermore, Middle Eastern cultures display a preference for a mediation-like form of dispute resolution. Their communitarian makeup instills individuals with a strong sense of respect to those persons who are senior to themselves, and a duty to protect those who they perceive as more vulnerable. People attempt to save face and take care not to inflict shame on others. A clear preference for informal methods of dispute resolution is viewed as a means of safeguarding peace and harmony within the professional or social group.[1139]

Islam supports the resolution of disputes by mediation. Arbitration and mediation, known as *sulh* in the sharia, are not necessarily distinguished from one another. Both provide a means of resolving disputes that are more amicable to all parties involved.[1140] Early Muslim traders often resorted to mediators in settling commercial disputes. The mediator was recognised for his prestigious social status, deep knowledge, impartiality and honesty in finding solutions to disputes, which disputants felt morally bound to honour.[1141]

[1138] PriceWaterhouseCoopers and Queen Mary, "Arbitration" (2008), 9.

[1139] Antaki, "ADR" (2009), 113-14.

[1140] See Khatchadourian, "Arbitration" (2010), 12.

[1141] Ibid.

Yet banks and financial institutions have traditionally shunned arbitration in favour of litigation for the following reasons:[1142]

(1) financial disputes typically involve straightforward payment claims and do not involve complex legal questions or fact finding, with the latter more suited for arbitration;
(2) arbitration does not provide for the possibility of default judgments or summary judgments, and as a result arbitration is not as efficient and cost effective as court proceedings;
(3) disputes about the tribunal's jurisdiction may lead to unnecessary delays;
(4) arbitrators tend to render more equitable decisions than judges;
(5) the flexibility of the arbitral process creates legal uncertainty;
(6) banks appreciate control of decisions by higher courts on appeal;
(7) arbitration can permit unnecessarily extensive document production (particularly compared with civil law courts);
(8) arbitration is problematic in multi-party disputes;
(9) arbitral confidentiality means that proceedings cause less embarrassment to the debtor; and
(10) awards have limited precedential value.

Moreover, arbitration can be more expensive as the arbitrator must be paid, the venue hired and, in some cases, the fees of an arbitration centre must be borne. However, the relative merits and disadvantages of arbitration versus litigation depend upon the type of transaction, the counterparty and the location of the assets.[1143] Furthermore, all courts should not be considered equal; litigation in one country might be more favourable than in another. For example, arbitration is favoured in transactions with counterparties in emerging markets.[1144]

[1142] Sheppard, "Arbitration" (2009).

[1143] Ibid.

[1144] Ibid.

Finally, all arbitral processes should not always be considered more costly or less efficient than litigation.[1145]

9.2.2 THE ENFORCEMENT OF ARBITRAL AWARDS

Arbitration agreements are generally recognised and enforced in England, Wales and Northern Ireland.[1146] The United Kingdom is a signatory to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention)[1147] so that arbitral judgments involving cross-border disputes are recognised and enforced in the UK. Article (2), section (1) provides that "each contracting state shall recognize an agreement in writing under which the parties undertake to submit to arbitration all or any differences which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not, concerning a subject matter capable of settlement by arbitration".[1148] Moreover, the treaty binds signatory states to recognise awards made outside their national borders unless the government has specifically opted to recognise only certain national jurisdictions.[1149] The convention has been incorporated in the UK Arbitration Act 1996. Section 101 provides that:[1150]

[1145] Ibid.

[1146] These are the jurisdictions that are subject to the UK Arbitration Act 1996.

[1147] New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards [1958].

[1148] New York Convention [1958].

[1149] Ibid.

[1150] Arbitration Act 1996, s 101.

(1) A New York Convention award shall be recognised as binding on the persons as between whom it was made, and may accordingly be relied on by those persons by way of defence, set-off or otherwise in any legal proceedings in England and Wales or Northern Ireland.

(2) A New York Convention award may, by leave of the court, be enforced in the same manner as a judgment or order of the court to the same effect.

As of 23 April 2010 144 states out of a total of 192 UN member states, had adopted the convention.[1151]

The UK Arbitration Act 1996 comprises almost all English arbitration law.[1152] Unlike conflict of laws principles which stipulate that only a state law can be used as the governing law of a contract, section 46 provides that:[1153]

1) The arbitral tribunal shall decide the dispute: (a) in accordance with the law chosen by the parties as applicable to the substance of the dispute; or (b) if the parties so agree, in accordance with such other considerations as are agreed by them or determined by the tribunal.

[1151] "New York Convention" [1958].

[1152] Arbitration Act 1996*;* c.f. Blackett, "Courts" (2009), 12.

[1153] Arbitration Act 1996*,* s 46(1)(a),(b).

Thus parties possess the legal right to settle a dispute according to the sharia or other non-state law or body of rules. Moreover, section 46 (1)(b) provides the parties and tribunal with greater latitude in deciding which set of rules they wish to employ.

Arbitration in the area of consumer banking is limited in the European Union by the terms of the Unfair Terms in Consumer Contracts Directive.[1154] The directive proscribes pre-dispute arbitration clauses in consumer contracts that have not been individually negotiated and are thus deemed unfair, i.e. those instances in which a significant imbalance between the rights and obligations of the contracting parties disadvantage the consumer.[1155] Any dispute that arises in conjunction with such clauses cannot be the subject of arbitration.[1156]

As financial institutions have increased transactions with developing countries the role of arbitration has become more important. This is a result of their uncertainty as to whether English law judgments or New York law judgements will be given effect in these jurisdictions. For example, financial institutions often include arbitration clauses in international loan transactions with counterparties based in the Middle East and Asia, South America, Russia and the Commonwealth of Independent States (CIS). Such contracts are structured to provide financial institutions with flexibility in the way in which potential disputes are resolved. In

---

[1154] Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts [1993] OJ L95/29, art 3(3). See UK statutory instrument: The Unfair Terms in Consumer Contracts Regulations 1999, SI 1999/2083, para 4(2)(a).

[1155] EC, "Summary" (1993).

[1156] Bantekas, "Arbitrability" (2009), 312.

London this is done by referring disputes to English courts with an option, exercisable by the bank in the event a dispute arises, to initiate arbitral proceedings instead. In England this option has been sanctioned in *Law Debenture Trust Corp plc v. Elektrim Finance BV*.[1157]

Cross-border Islamic financial transactions stand to benefit from the New York Convention and its rules of enforcement for arbitral awards. Leading issuers of *sukuk,* including Bahrain, Malaysia, Qatar and the United Arab Emirates (UAE) are signatories to the treaty.[1158] Key industries in the Middle East such as shipping, energy, oil and gas, and insurance have shown themselves most likely to take advantage of international arbitration.[1159] Yet significant uncertainty attaches to the enforcement of arbitral awards in Middle Eastern courts. Theoretically, signatories to the New York Convention should enforce arbitral awards without re-examination of the award.[1160] Yet, in practice, enforcement has proved to be uncertain.

For example, in Saudi Arabia the enforcement of arbitral awards involving financial transactions is highly uncertain due to the sharia and its prohibitions of *ribā* and *gharar*. In general, none of the sharia courts in Saudi Arabia would even entertain a dispute involving a prohibited financial activity, let alone approve an arbitral award that involved the payment of interest.[1161] Furthermore, any arbitral award governed by a law other than the sharia or Saudi law would be

---

[1157] Sheppard, "Arbitration" (2009). See [2005] EWHC 1412(Ch).

[1158] Jarrar, "Awards" (2009), 12.

[1159] PriceWaterhouseCoopers and Queen Mary, "Arbitration" (2008), 9.

[1160] Linklaters, "Developments" (2011).

[1161] Baamir, "*Shari'a"* (2010), 154-58.

reviewed for its sharia compatibility. Awards found to contradict with the sharia are subject to excluding the prohibited activity from the award or re-submitting the dispute to a different authority.[1162]

In the UAE, however, two recent foreign arbitral awards were enforced without re-examination of the merits of the award, which may lead to greater confidence in the UAE amongst the international business community.[1163] This optimism is qualified by the fact that legal systems in the Middle East do not base decisions on precedent and the possibility exists that another court may reach a different decision in any subsequent action, thus compounding the uncertainty of enforceability.[1164]

In the next section the way in which Islamic financial arbitral awards have been enforced in English courts is examined.

9.3 THE ENFORCEMENT OF ARBITRAL AWARDS IN ENGLISH COURTS

Sanghi Polyesters Ltd v The International Investor KCSC[1165] offers an example of how arbitral awards involving Islamic financial transactions will be enforced in English courts. In general, the

---

[1162] Ibid., 162.

[1163] Linklaters, "Developments" (2011).

[1164] Ratings, "Fitch's Approach" (2007), 3.

[1165] [2000] All ER (D) 93.

case demonstrates that the right to appeal arbitral awards will be very limited. The case concerned a financing agreement based on an Islamic *istiṣnā'* contract (purchase or hire agreement) in which The International Investor KCSC (TII) furnished Sanghi Polyesters Ltd (SPL) with US $5 million to produce and export polyester yarn. SPL failed to pay sums due under the contract and subsequently failed to perform under various extension agreements created to assist SPL. Thereafter, TII began arbitration proceedings according to the agreements' arbitration clause which provided: "This dispute shall be governed by the Laws of England except to the extent it may conflict with Islamic sharia, which shall prevail".[1166] The arbitrator awarded TII the principal and profit it had claimed but disallowed some additional damages of approximately $600,000.[1167]

The arbitration was held under the auspices of the International Chamber of Commerce (ICC) based in London. The parties had chosen the Arbitration Act 1996 as the law of the forum. Section 69 of the act permits parties "to appeal against a question of law arising out of the Award in certain circumstances but only if the parties have not "otherwise agreed".[1168] The court found that the parties, in deciding to submit their dispute to arbitration, had waived their right to appeal in accordance with article 24 of the ICC (the *lex arbitri*). Hence, they had clearly "otherwise agreed" and Mackie J dismissed this argument.

[1166] Ibid., transcript.

[1167] Ibid.

[1168] Arbitration Act 1996, s 69.

According to section 69(3) the following issues would enable a party to appeal an arbitral award:[1169]

a) that the determination of the question will substantially affect the rights of one or more of the parties;
b) that the question is one which the tribunal was asked to determine;
c) that on the basis of the findings of fact in the award (i) the decision of the tribunal on the question is obviously wrong, or (ii) the question is one of general public importance and the decision of the tribunal is at least open to serious doubt;
d) that, despite the agreement of the parties to resolve the matter by arbitration, it is just and proper in all the circumstances for the court to determine the question.

The court summarily dismissed SPL's applications which sought to make effect of s 69(3) on the basis of procedural errors committed by the arbitrator and thus confirmed the high threshold necessary for gaining leave to appeal.

Another case, *Halpern v Halpern,*[1170] provides insight into the complex conflict of law considerations judges must make in resolving arbitral disputes which parties seek to enforce under English law. While the case addresses a number of contractual issues, including duress, just one subject of the appeal will be examined below; namely, whether Jewish law can be the applicable law of a contract. In this light *Halpern* is important in terms of the way in which the

---

[1169] Ibid., s 69, sub-s 3.

[1170] [2007] EWCA Civ 291.

court interpreted section 46(1)(b) of the Arbitration Act 1996. As noted above, section 46 (1)(b) allows the arbitral tribunal to decide the dispute, if the parties so agree, in accordance with 'such other considerations' as are agreed by them. Since the court ruled that the seat of arbitration was in England, it decided that 'such other considerations' would permit the tribunal to apply the parties' choice of Jewish law or non-national law to govern a certain part of the contract[1171] "under which matters of interpretation can be assisted by rules or a law different from the applicable law of the contract".[1172] Because the dispute involved an arbitration, which applied Jewish law, the application of Jewish law was material to the contract.

The claimants in this appeal sought the enforcement of an arbitral compromise which had taken place before a Zurich-based Beth Din composed of three Rabbis. The arbitration had sought to resolve issues concerned with the status of an inheritance dispute. All the parties were devout orthodox Jews and had agreed to submit their inheritance disputes to arbitration. The compromise took the form of a written agreement which did not expressly state which law was to govern the contract.[1173] The defence challenged the validity of the compromise on the basis that under Jewish law the compromise would be unlawful. The defence "pleaded that Jewish law (*halakha*) was intended to be the *lex causa* as well as the *lex curia,* and would regulate procedure;" the result of which would render the compromise agreement void.[1174]

[1171] Redfern et al., "*Arbitration"* (2009), 227.

[1172] *Halpern* (n 1172) [35].

[1173] Levy, "Duress" (2006), 936.

[1174] *Halpern* (n 1172) [14] subpara vii.

In the event that a law has not been chosen to govern the agreement section 46(3) of the Arbitration Act 1996 provides that the court must have reference to the conflict of laws rules which it considers applicable".[1175] Furthermore, article 4 of the Rome Convention provides that:[1176]

> To the extent that the law applicable to the contract has not been chosen in accordance with Article 3, the contract shall be governed by the law of the country with which it is most closely connected. Nevertheless, a severable part of the contract which has a closer connection with another country may by way of exception be governed by the law of that other country.

The circumstances of the case involved English law, Swiss Law and Jewish law – the laws of countries as well as a non-state law. The absence of the parties' choice or consent as to the substantive law of the compromise agreement made the consideration of Jewish law as the applicable law of the agreement, redundant. Furthermore, *Beximco* established that Article 1(1) of the Rome Convention "makes it clear that the reference to the parties' choice of "the law" to govern a contract is a reference to the law of a country. It does not sanction the choice or application of a non-national system of law".[1177] The court affirmed the supremacy of national legal systems in citing the well known case of *Amin Rasheed Shipping Corp v Kuwait Insurance*

[1175] Arbitration Act 1996, s 46, sub-s 3.

[1176] *Halpern* (n 1172) [27].

[1177] Ibid., [21].

Co.[1178] In that judgment Lord Diplock said that "contracts are incapable of existing in a legal vacuum. They are mere pieces of paper devoid of all legal effect unless they were made by reference to some system of private law which defines the obligations assumed by the parties to the contract by their use of particular forms of words and prescribes the remedies enforceable in a court of justice for failure to perform any of those obligations".[1179]

In applying the Rome Convention, the court concluded that the contract had been reached under the auspices of a Beth Din in Switzerland; and the parties resided in England and brought their claim to an English court. Further, the parties to the compromise did not propose the application of Swiss law to the agreement. Therefore, the court found that England and hence English law represented the "closest connection" to the circumstances of the case.

In effect, the Court of Appeal resolved the matter by taking cognisance of the fact that the dispute was initially an arbitral dispute and therefore required the court to apply the Arbitration Act 1996. In particular, the court's reference to section 46(1)(b) of the Arbitration Act convinced the court that "such other considerations" could make the provision of Jewish law material. The finding reaffirms the judgment in *Musawi v RE International Ltd*[1180] that paragraph 46(1)(b) entitled the parties to an arbitration to employ Shia sharia law as the substantive law of the

---

[1178] [1984] AC 50.

[1179] Ibid., 66.

[1180] [2007] All ER (D) 222(Dec).

dispute.[1181] The court in *Halpern* said that the "solution under which matters of interpretation can be assisted by rules or a law different from the applicable law of the contract, but matters affecting the contract as a whole must be dealt with by the applicable law is […] consistent with the Convention".[1182] Apparently, the court sees its approach to this matter as one of determining the extent to which the applicable law would enable the provision of Jewish law to influence a part of the contract.[1183]

CONCLUDING REMARKS

The *Symphony Gems* case underscores the complex interplay of multiple legal systems and norms that becomes apparent in the process of enforcing Islamic financial transactions. Furthermore, the case provides an illustrative example of how the *murābaḥah* is used by the Islamic financial industry as a trade financing contract and what legal risks arise from its particular terms and conditions. Finally, the case illustrates the types of arguments that have resurfaced in Islamic financial disputes, including claims of sharia non-compliance and *ultra vires* transactions.

The *Beximco* case represents a persuasive judgment by an English court that prevents parties from choosing the sharia as the governing law of their contract. According to the Rome

---

[1181] Ibid., [46](1)(b).

[1182] *Halpern* (n 1172) [35].

[1183] Ibid., [36].

Convention, to which the UK is a signatory, and its subsequent replacement (Rome I), a non-state law may not be chosen by the parties to govern their contract. However, *Beximco* illustrated that the sharia could then be incorporated into the contract pursuant to English law's doctrine of incorporation in accordance with Rome I, recital 13 of the Preamble. In *Beximco*, however, the Court of Appeal ruled that the inclusion of the sharia in the governing law clause was indeterminate and did not meet the black letter law requirements of that doctrine. The decision has caused consternation amongst many Muslims who argue that the sharia should be allowed to govern Islamic financial transactions.

A theoretical alternative for allowing parties to choose the sharia as the governing law of their contract concerns the practice of arbitration. However, for a number of reasons, banks and other financial institutions have traditionally shunned arbitration in favour of litigation. This practice may be changing as financial institutions increase the number of transactions with emerging markets and choose to include arbitration clauses in their agreements. Furthermore, arbitration accords with the preferences and attitudes of Middle Eastern cultures and so may be a viable alternative for Islamic financial disputes.

Arbitral awards are enforceable in England, Wales and Northern Ireland pursuant to the Arbitration Act 1996. Cross-border transactions that have assets located in the Middle East or involve corporations incorporated in Middle Eastern jurisdictions face uncertainty whether local commercial courts will enforce arbitral awards. For example, commercial courts in Saudi Arabia

will often re-examine foreign arbitral awards on their merits and compatibility with the sharia, despite being signatories to the New York Convention.

Several cases illustrate the way in which arbitral awards will be enforced in the United Kingdom. In those decisions English courts had recourse to the Arbitration Act and its provisions for determining whether arbitral awards should be given the force of English law.

CHAPTER 10: CONCLUSIONS

The concluding discussion examines three interrelated themes highlighted by the thesis. These are: the challenges of creating sharia-authentic financial structures; the imperative of reconciling value systems by levelling the playing field; and the importance of standardisation as a means of establishing a coherent, certain and transparent legal framework for a global LIF.

These themes are examined in turn, followed by a number of proposals for resolving the complex challenges that each presents to the development of a global legal framework for the Islamic finance industry.

10.1 RESOLVING THE AUTHENTICITY ISSUE

The central legal issue raised by this thesis' examination of the transformation of the sharia in modern financial markets concerns the problem of devising sharia-authentic legal structures, i.e. modern structures which evince an "authentic" connection with classical Islamic commercial law. The transformation of the sharia via its modern articulation and implementation in modern financial markets has created a multiplicity of hybrid MLIFs that together interact to comprise the global LIF. The global LIF's municipal variants (MLIFs) arise from the law's implementation in municipal legal systems, which vary in terms of their legal and regulatory framework. However, the hybridity and municipal diversity of the developing legal system ultimately undermine the law's claim to sharia-authenticity, since these attributes underscore the LIF's innovative

composition rather than classical authenticity, and also fall short of offering legally coherent, certain and transparent financial structures; the necessary elements for financial markets to flourish.

The religious risks that result from this sharia authenticity problem undermine confidence in the industry and its financial offerings. The following proposals address different thematic elements of the thesis, yet all provide incremental solutions to the problem of sharia authenticity. Ultimately, these proposals seek to facilitate clarity, transparency and a more cohesive framework for the facilitation of MLIFs and their interaction with the globally relevant LIF.

The first theme concerns the thesis's contribution to revising perceptions of Islamic commercial law, the basis from which the modern industry derives its inspiration.

10.1.1 REEVALUATING THE ISLAMIC COMMERCIAL LEGACY

Research findings indicate that the sharia, especially its commercial rules, is a pragmatic and flexible legal system that is amenable to adaptation, and reserves an important role for customary practices (*'urf*). It is thus plausible that the legal solutions adopted by jurists through their application of Islamic financial *ijtihād* have a genuine legal basis in the classical tradition (*fiqh*), and may resemble the ways in which jurists made historical commercial transactions legitimate (*ḥalāl*). This is a more important insight than has generally been acknowledged. Unfortunately, in today's highly politicised Muslim world many Muslims and outsiders alike view

the sharia as a fairly rigid legal system, not particularly amenable to legal adaptation, not to mention modern financial practices. The findings from this thesis speak otherwise, however, and it is hoped that this insight will make a contribution to altering this perception.

However, it is clear that a change of perception alone is not sufficient to convince devout consumers, for they will remain sceptical about IF products, so long as their substantive effect resembles that of conventional products. Authenticity then becomes a byword for the desire to create an original economic system that does not take its cues from conventional financial values, which seem to have led markets into the abyss. Therefore, solutions to the challenges and problems raised by this central issue must address ways in which the Islamic tradition can be more effectively accommodated so as to develop on its own terms. This topic is examined in the following section.

10.2 RECONCILING VALUE SYSTEMS

The thesis showed that the UK financial services environment does not, in principle, prevent the Islamic finance industry from developing alternative financial markets. Yet the values of the global economy, in particular those that underlie the current institutional framework of liberal economies such as the UK, are dominant. In facilitating the stateless LIF in a municipal legal architecture, the LIF necessarily interacts with, adapts to, and sometimes conflicts with the dominant values of the global economy. Despite this subordination some areas of legal conflict have been reconciled that begin to bridge the gap between value systems. Consider, for

example, the government's abolition of double stamp duty in 2003, which ushered in a range of new Islamic financial activity. Yet more deep-seated structural imbalances remain that require modification for a truly alternative financial system to grow. What is perhaps surprising is that many of these reform ideas emanate from conventional financial circles as ways to rebalance the global economy. Indeed, many of the principles behind such proposals could be considered "Islamic".

For example, consider the UK government's facilitation of *mudāraba* partnership and profit- and loss- investment partnerships. The profit share arising from these transactions, if treated as equity-based investments, would normally not be tax deductible by the IFI for the reason that dividends are subject to disadvantageous tax treatment – taxes are payable – whereas interest is generally tax-deductible.[1184] The government approached this problem by amending Finance Act 2005, which enabled *mudāraba* dividends to be treated as interest paid on loans (and hence given tax-deductibility). However, the example clearly illustrates the current financial architecture's underlying incentives, which prioritise a debt-based, highly leveraged economy to the disadvantage of equity-based investment. An incremental solution to this inequity would establish a tax neutral framework by de-incentivising leverage and associated tax-based regulatory arbitrage. A neutral tax framework would create incentives to invest in equity, which is compatible with Islamic principles.

[1184] Haldane, "Control Rights" (2011), 7.

Another way of reconciling value systems would be to review the merit of according the lowest risk-weighting to sovereign debt and other debt-based investments for capital adequacy and liquidity requirements.[1185] Although debt is usually seen as a safer investment than equity, the lessons learned from the 2008 financial crisis indicate that this is not always the case, and that undue reliance upon it may have negative consequences.[1186] As for sovereign debt, its safety has been put into question in recent months by the problems experienced by some of the most highly-rated developed economies including the United States,[1187] the United Kingdom[1188] and France.[1189]

IFIs cannot avail themselves of interest-bearing debt and so cannot take advantage of the low-risk weighting of these instruments for capital adequacy or liquidity purposes. This presents an acute challenge for the alternative asset-backed industry.

The Islamic Financial Services Board (IFSB), which has issued capital adequacy standards for IFIs,[1190] should be given greater recognition in global efforts to restructure the financial reserves

---

[1185] Analytics, “New Framework” (2011), 9.

[1186] Sovereign debt figures heavily in states’ current capital regimes, a factor which has exacerbated the Eurozone crisis. Reliance on these assets for the determination of liquidity ratios is even more problematic. See Analytics (n 1185) 9.

[1187] US Sovereign debt was downgraded by S. & P. for the first time in 2011. See Appelbaum and Dash, "S.& P. Downgrades" (2011).

[1188] The UK sovereign debt rating is under pressure. See BBC, “Warning on UK Debt" (2009).

[1189] In addition to France, the sovereign debt rating of eight other states was downgraded. See Schneider and Cody, "Standard & Poor’s Cuts" (2012).

[1190] IFSB, “Capital Adequacy” (2005).

and liquidity ratios of financial institutions via the Basel process. The extent to which IFSB standards should be accommodated or made applicable with respect to IFIs must be based on a wholesale reconsideration of the risks arising from particular transactions.

Furthermore, in the UK the PRA should invest considerable effort in helping the industry to devise an effective interbank lending framework that is not based on interest. Basel III's increased liquidity ratio requirements highlight the enormous challenges that IFIs must surmount to remain competitive market players. Helping IFIs to create an established liquidity framework would ease liquidity challenges to a considerable extent and potentially make room for the development of more authentic products and services.

Finally, the government should consider developing a sharia-compliant deposit guarantee scheme, possibly modelled on the *takāful* insurance model. By making alternative arrangements for assisting depositors in the event of monetary loss, the government can assure Muslim consumers that their investments will be compatible with the teachings of Islam from start to finish.

Another important way of enhancing sharia authenticity involves the global effort to standardise the LIF, a topic which is addressed in the following section.

10.3 STANDARDISATION OF THE LIF

One of the most important ways of addressing the sharia-authenticity problem of the developing LIF concerns the manner in which sharia-inspired transactions are interpreted by courts. For example, English courts have shown a historical reluctance to allow the sharia to be chosen by parties as the governing law of their contracts. This reluctance was illustrated most recently in *Beximco* which, as the most authoritative case concerning the governing law issue, confirmed that the sharia cannot be chosen as the proper law of a contract. Financial markets and legal practitioners responded positively, since the judgment clarifies the way in which English courts will deal with this type of issue. Therefore, *Beximco* establishes legal certainty and places the moral burden of structuring sharia-compatible contracts on the contracting parties themselves.

Yet the lessons of *Beximco* do not satisfy devout Muslim consumers' desire for sharia-authentic contracts since a municipal legal system, namely English law, continues to govern their interpretation. The recognition that the sharia cannot be the governing law remains a source of religious insecurity and sharia legal confusion, in the sense that consumers must recognise the difference between the governing law and the sharia aspects of the transaction. Arguably, *Beximco* paves the way for a higher level of religious risks in IFIs, since the judgment allows just about any transaction to be labelled 'sharia-compliant' as long as the parties have agreed amongst themselves that this is indeed the case. The result is that sharia-compatibility has become a simple marketing issue, not a legal concern. Captive consumers do not have judicial recourse in the event that they belatedly discover their investment products are non-compliant,

because there is no single definition of what is meant by labelling a transaction sharia-compliant. A Muslim investor is expected to know what is sharia-compatible and what is not or at least be willing to rely on an SSB's fatwa.

A partial solution to this problem is to encourage the industry to incorporate specific provisions, such as AAOIFI sharia standards, into IF contracts. So long as such provisions are sufficiently specific, they operate "as a set of contractual terms agreed upon between the parties".[1191] English courts will refer to incorporated standards in their interpretation of English law contracts so that the legal substance of contracting parties' objectives is achieved.[1192] The determinacy of such standards allows easier judicial interpretation and they do not overstep the appropriate role of religion in UK public life. Furthermore, the interpretation and resolution of disputes on the basis of SSB-accredited sharia standards would strengthen the authenticity claims of the Islamic financial industry.

Despite this proposal's merits as well as other legal solutions such as arbitration, which allows parties to settle disputes governed by non-state legal systems, a major consequence of *Beximco* is that the LIF will continue to be conceived outside of municipal legal systems. But this trend need not be an impediment to the industry or its efforts to standardise the LIF; in fact, as

---

[1191] Referring to 32-087 and 32-086 Dicey & Morris, cited in *Beximco* (n 1058) [50] and *Nea Agrex* (n 1096)

[1192] *Nea Agrex* (n 1096). The court ruled that a paramount clause provision could incorporate the Hague rules into a charterparty.

long as a general level of legal standardisation can be achieved, it may be beneficial, since the non-national status of the law may lend it more religious legitimacy.

Another important area of standardisation concerns the ways in which the FSA and its successor, the PRA, can encourage IFIs to adopt sharia standards in their market-making practices. The current *ad hoc* approach taken by IFIs in utilising these standards is counterproductive and creates legal uncertainty. The regulatory authority can facilitate standardisation by revising its process of supervision of the sharia law-making functions of SSBs. While the FSA/PRA cannot intervene directly in the sharia law-making process, this does not prevent it from supervising the process as a whole. Direct supervision of SSB governance would force IFIs to comply with sharia governance and audit rules to which each has chosen to subscribe.

A further measure would begin to address the wide range of problems concerning the credentials, conflicts of interest and judgment of sharia scholars. This involves the establishment of self-regulatory associations to vet, licence and provide training opportunities to scholars in a formal, standardised and transparent process. National regulators can play an important role in encouraging the formation of sharia scholar self-regulatory associations and thus help to strengthen consumer protections.

Finally, the UK government should take the opportunity seriously to reconsider the economic, legal and political merits of issuing a sovereign sukuk. As highlighted in the thesis, sovereign

issuance would provide a benchmark for subsequent issuances and would generate new growth and development in the UK-based industry. It would also provide a legal template for sukuk issuance that would encourage the standardisation of the LIF.

All of the above proposals would help to standardise Islamic financial transactions, strengthen sharia authenticity claims and assist in reconciling competing value systems. Nevertheless, these proposals, even if carried out to the fullest extent, are not likely to be greeted by everyone, since Islamic law has a long history of religious contingency. Contingency, the reader will recall, is the quality of a religious law that enables a multiplicity of valid and binding interpretations to exist side-by-side. Standardisation, despite its clear advantages in the mundane world, is a secular feature of law that reflects the authority of mankind to determine the structure and rules of society. Some Muslims may find this morally repugnant, since it may not accord with the most basic sharia principle; namely, that God is the lawgiver.[1193] Despite this cautionary note, however, almost all Islamic finance practitioners realise that standardisation is the most important means of developing a coherent legal and regulatory framework for the Islamic finance industry. It is by far the most important modern tool to help Islamic finance practitioners overcome the complex challenges of articulating and implementing the LIF.

[1193] There is a lively debate concerning this issue. For example, see Hamoudi, “Death” (2010); Mayer, “Methodology” (1990); and Peters, “Jurist’s Law” (2002).

10.4 FUTURE RESEARCH

This project has shown the challenges associated with the UK MLIF. Much work remains to be done to understand the development of MLIFs in other jurisdictions where Islamic finance has been facilitated. Comparative work with other jurisdictions would clarify the way in which the LIF is developing, whether trends are ascertainable, and what differences or idiosyncrasies exist between jurisdictions. Jurisdictions that have created dual legal and regulatory frameworks to facilitate the industry – such as Malaysia and Bahrain – should be given special attention as they may offer a model that can be fruitfully juxtaposed with the UK's integrationist model. In general, comparative analyses, which are almost absent in the current literature, offer important insights into the ways in which the global LIF is conceived and taking shape across the globe.

Comparative research provides a framework for more conceptual work regarding the development of the LIF. Further work in this area may attract greater scholarly attention to the LIF as a globally relevant law, perhaps akin to an Islamic *lex mercatoria*.[1194] Such a marked shift in how the law of the industry is perceived would place greater weight on understanding its generation, its legal processes and developing hierarchies. It may help in visualising a law that transcends the state/non-state distinction that, by itself, is of limited use.[1195]

[1194] A set of legal norms, procedures and institutions generated by and for global commerce that exist independently of the state. Foster critically analyses the concept of the *lex mercatoria* in Foster, "Foundation Myth" (2005), which is a useful starting point for this analysis.

[1195] Michaels, "Lex Mercatoria" (2007), 468.

At the micro-level, continuing analysis of the *sukuk*, the legal forms used, and the municipal legal challenges that arise, will play a crucial role for the further growth and development of the industry. As more issuances take place, secondary markets develop and disputes involving *sukuk* are resolved in commercial courts, much work will need to be done to clarify the industry's practices and thus help chart the course for the Islamic financial industry.

10.5 FINAL REMARKS

The pluralistic legal and economic challenges that have fundamentally transformed the sharia in modern financial markets continue to raise hurdles to its development. This thesis showed ways in which these factors have irreparably altered the sharia via a process of legal hybridisation; a process, which, paradoxically, has made the classical legal tradition relevant once again. Yet the sharia's transformation into a LIF comprised of multiple MLIFs requires a concerted effort to authenticate the law, so that Muslim consumers are able to connect with the LIF's religious origins.

The thesis has shown sharia authenticity to be the most important element in the process of building a modern, certain and transparent LIF. This thesis's focus on the development of a UK MLIF offers many important insights into the problems, challenges and successes of developing an MLIF. The lessons of this case study can be usefully applied in further research so as to chart the most effective and sharia authentic way of developing MLIFs across the globe.

BIBLIOGRAPHY

AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions). "AAOIFI Publishes New Standards". (2011). Available at: http://www.aaoifi.com/AAOIFI%20-%20PR-Click%20Jordan%20-%20New%20Standards.pdf.

———. "Accounting, Auditing and Governance Standards for Islamic Financial Institutions". Manama, 2001.

———. *Shari'a Standards*. Manama: Accounting and Auditing Organization for Islamic Financial Institutions, 2004-2005.

———. "Sukuk Standard". (2008). Available at: http://www.aaoifi.com/aaoifi_sb_sukuk_Feb2008_Eng.pdf

Abdul-Rahman, Yahia. *The Art of Islamic Banking and Finance*. Hoboken:Wiley, 2010.

Abdullah, Daud Vicary. "Liquidity Management in Institutions Offering Islamic Financial Services". 1-26. Paper Presented at Second Islamic Financial Stability Forum. Jeddah, 2010. Available at: http://www.ifsb.org/docs/David_Vicary_IFSF_paper_FINAL.pdf

Adam, Nathif J, and Abdulkader Thomas. *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk*. London: Euromoney Books, 2004.

Agha, Oliver Ali, and Claire Grainger. "Sukuk: Default or No Default?" *Credit*, January 2010. Available at: http://www.aghashamsi.com/downloads/Sukuk%20Default%20Article%20pdf.pdf

Aghnides, Nicolas P. *Mohammedan Theories of Finance*. Lahore: Premier Book House, 1961.

Ahmad, Abu Umar Faruq. *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia*. Boca Raton: Brown Walker Press, 2010.

Ahmad Hidayat, Buang. *Studies in the Islamic Law of Contracts: The Prohibition of Gharar*. Kuala Lumpur: International Law Book Services, 2000.

Ahmad, Khurshid. "Foreword". In *Banking without Interest*, edited by Muhammad Nejatullah Siddiqi. Leicester: The Islamic Foundation, 1983.

Ahmad, Khurshid, and Zafar Ishaq Ansari. "Mawlana Sayyid Abul A'la Mawdudi: An Introduction to His Vision of Islam and Islamic Revival". In *Islamic Perspectives: Studies in Honour of Mawlana Sayyid Abul A'la Mawdudi*, edited by Khurshid Ahmad and Zafar Ishaq Ansari. Leicester: The Islamic Foundation, 1979.

Ahmed, Habib. "Islamic Law, Adaptability, and Financial Development". *Islamic Economic Studies* 13, no. 2 (2006): 79-101.

———. *Product Development in Islamic Banks*. Edinburgh: Edinburgh University Press, 2011.

Ahmed, Taha Eltayeb. "Accounting Issues for Islamic Banks". In *Islamic Finance: Innovation and Growth*, edited by Simon Archer and Rifaat Ahmed Abdel Karim, 109-23. London: Euromoney Books; AAOIFI, 2002.

Ahmed, Ziauddin. "Prohibition of Interest in Islam". *Journal of Islamic Banking and Finance* 1, no. 1 (1984): 19-29.

Ainley, Michael, Ali Mashayekhi, Robert Hicks, Arshadur Rahman, and Ali Ravalia. "Islamic Finance in the UK: Regulation and Challenges". edited by Financial Services Authority, 3-33. London: Financial Services Authority, 2007.

Al-Amine, Muhammad Al-Bashir Muhammad. "Istisna' and Its Application in Islamic Banking". *Arab Law Quarterly* 16 (2001): 22-48.

Aldohni, Abdul Karim. *The Legal and Regulatory Aspects of Islamic Banking*. London: Routledge, 2011.

"Al-Majallah Al-Ahkam Al-'Adaliyya". (2011). Available at: http://www.ummah.net/Al_adaab/fiqh/majalla/index.html.

Al-Suwailem, Sami. "Towards an Objective Measure of Gharar in Exchange". *Islamic Economic Studies* 7, no. 1 and 2 (2000): 61-102.

Al-Zuhayli, Wahbah. *Financial Transactions in Islamic Jurisprudence*. Translated by Mahmoud A. El-Gamal. Vol. I. Damascus: Dar al-Fikr, 2003.

Ali, Salman Syed. "Islamic Banking in the MENA Region", 1-45. Jeddah: Islamic Development Bank - Islamic Research and Training Institute, 2011.

Allot, Antony. *The Limits of Law*. London: Butterworths, 1980.

Amin, Mohammed. "British Government Policy on Islamic Finance". (2010). Available at: http://www.mohammedamin.com/Islamic_finance/British_Government_Policy_on_Islamic_finance.html.

———. "Liquidity Management at UK Islamic Banks". (2011). Available at: http://www.mohammedamin.com/Islamic_finance/Liquidity-management-at-UK-Islamic-banks.html.

———. "The New UK Tax Law on Sukuk". *New Horizon*, no. Jan-March (2008): 1-4.

———. "Shari'ah-Compliant Finance: UK Regulation". *New Horizon*, no. January - March (2010): 1-2.

———. "Why Has Retail Islamic Banking Not Taken Off in the UK?". (2010). Available at: http://www.mohammedamin.com/Islamic_finance/Why_has_retail_Islamic_banking_not_taken_off_in_the_UK.html

Analytics, Federal Financial. “A New Framework for Systemic Financial Regulation: Simple, Transparent, Enforceable and Accountable Rules to Reform Financial Markets”. (2011). Available at: http://www.fedfin.com/images/stories/client_reports/complexityriskpaper.pdf

Anderson, J.N.D. *Islamic Law in the Modern World*. London: Stevens & Sons Limited, 1959.

Anderson, Norman. *Law Reform in the Muslim World*. London: Athlone Press, 1976.

Antaki, Nabil. "Muslims' and Arabs' Practice of ADR”. *NYSBA New York Dispute Resolution Lawyer* 2, no. 1 (2009): 113-15.

Appelbaum, Binyamin, and Eric Dash. “S.& P. Downgrades Debt Rating of U.S. for the First Time”. (2011). Available at: http://www.nytimes.com/2011/08/06/business/us-debt-downgraded-by-sp.html.

Arabi, Oussama. "Contract Stipulations (Shurut) in Islamic Law: The Ottoman Majalla and Ibn Taymiyya”. *International Journal of Middle East Studies* 30, no. 1 (1998): 29-50.

Archer, Simon, and Rifaat Ahmed Abdel Karim. "Supervision of Islamic Banks and Basel II: The Regulatory Challenge”. In *Islamic Finance: The Regulatory Challenge*, edited by Simon Archer and Rifaat Ahmed Abdel Karim, 1-11. Singapore: John Wiley & Sons (Asia), 2007.

Askari, Hossein, Zamir Iqbal, and Abbas Mirakhor. *New Issues in Islamic Finance and Economics: Progress and Challenges*. Singapore: John Wiley & Sons (Asia), 2009.

Baamir, Abdulrahman Yahya. *Shari'a Law in Commercial and Banking Arbitration: Law and Practice in Saudi Arabia*. Farnham: Ashgate, 2010.

Bakar, Mohd Daud. "The Shari'a Supervisory Board and Issues of Shari'a Rulings and Their Harmonisation in Islamic Banking and Finance”. In *Islamic Finance: Innovation and Growth*, edited by Simon Archer and Rifaat Abdel Karim, 74-88. London: Euromoney Books, 2002.

Bakr, Dalila Abu. "Basel II Enhances Islamic Banks”. *Islamic Finance Asia*, 2008.

Balala, Maha-Hanaan. *Islamic Finance and Law: Theory and Practice in a Globalized World*. London: I.B. Tauris, 2011.

Baldwin, Robert, and Martin Cave. *Understanding Regulation: Theory, Strategy, and Practice*. Oxford: Oxford University Press, 1999.

Ballantyne, William. *Commercial Law in the Arab Middle East: The Gulf States*. London: Lloyd's of London Press, 1986.

———. "Commercial Law: The Conflict in Shari'a and Secular Law". In *International Review of Comparative Public Policy*, edited by Sohrab Behdad and Farhad Nomani, 225-48. Greenwich: JAI Press 1997.

———. *Essays and Addresses on Arab Laws*. Richmond: Curzon, 2000.

———. "The Shari'a and Its Relevance to Modern Transnational Transactions". In *Arab Comparative & Commercial Law*. London: Graham & Trotman, 1987.

———. "The Shari'a: The Use of Money". 1-19. London: Serle Court, 2010.

Ballard, Roger. "Coalitions of Reciprocity and the Maintenance of Financial Integrity within Informal Value Transmission Systems: The Operational Dynamics of Contemporary Hawala Networks". *Journal of Banking Regulation* 6, no. 4 (2005): 319-52.

Bälz, Kilian. "Islamic Finance for European Muslims: The Diversity Management of Shari'ah-Compliant Transactions". *Chicago Journal of International Law* 7, no. 2 (2007): 551-67.

———. "Islamic Law as Governing Law under the Rome Convention". *Uniform Law Review* 6, no. 43 (2001): 37-49.

———. "A Murabaha Transaction in an English Court". *Islamic Law and Society* 11, no. 1 (2004): 117-34.

Bank of England. "Memorandum of Understanding Between HM Treasury, the Bank of England and the Financial Services Authority". 1-7. London, n.d. Available at: http://www.bankofengland.co.uk/financialstability/mou.pdf

Bank of England and Financial Services Authority. "The Bank of England, Prudential Regulatory Authority". 1-23. London, 2011. Available at: http://www.bankofengland.co.uk/publications/other/financialstability/uk_reg_framework/pra_approach.pdf

Banking, Independent Commission on. "Interim Report: Consultation on Reform Options". 1-214. London: Independent Commission on Banking, 2011.

Bantekas, Ilias. "Arbitrability in Finance and Banking". In *Arbitrability: International & Comparative Perspectives*, edited by Loukas A. Mistelis and Stavros L. Brekoulakis, 293-316. The Netherlands: Wolters Kluwer, 2009

Barzilai, Davide. "Syndicated Financing". In *Islamic Project Financing: 2nd Annual One-Day Workshop*. London: Institute for Islamic Banking and Insurance, 2010.

BBC, British Broadcasting Corporation. “Rating Agency Warning on UK Debt”. (2009). Available at: http://news.bbc.co.uk/1/hi/business/8061019.stm.

BCBS (Basel Committee on Banking Supervision). "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements”. 1-69: Banking Committee on Banking Supervision, 2010.

———. "Basel II and Revisions to the Capital Requirements Directive”. 1-3. Basel: Basel Committee on Banking Supervision, 2010.

Belder, Richard de. "Shari'ah-Compliant Project Financing Securitisation Structures”. In *Islamic Project Financing: 2nd Annual One-Day Workshop*. London: Institute of Islamic Banking and Insurance, 2010.

Benston, George J., Michael Bromwich, Robert E. Litan, and Alfred Wagenhofer. *Worldwide Financial Reporting: The Development and Future of Accounting Standards*. Oxford: Oxford University Press, 2006.

Benthall, J., and J. Bellion-Jourdan. *The Charitable Crescent: Politics of Aid in the Muslim World*. New York: I.B. Tauris, 2003.

Bergsträsser, Gotthelf. "Anfänge Und Charakter Des Juristischen Denkens Im Islam”. *Der Islam* 14 (1925): 76-82.

Bhambra, Hari. "Supervisory Implications of Islamic Finance in the Current Regulatory Environment”. In *Islamic Finance: The Regulatory Challenge*, edited by Simon Archer and Rifaat Ahmed Abdel Karim, 198-212. Singapore: John Wiley & Sons (Asia), 2007.

Bi, Farmida. "Islamic Project Finance: Project Finance Sukuk”. In *Islamic Project Financing: 2nd Annual One-Day Workshop*. London: Institute of Islamic Banking and Insurance, 2010.

———. "Structuring Shari'a-Compliant Legal Transactions: The Experience of Norton Rose”. In *Islamic Finance in Europe*. Rome: Universitá Degli Studi Di Roma Tor Vergata, 2011.

BIS (Bank for International Settlements). "The Group of Governors and Heads of Supervision Reach Broad Agreement on Basel Committee Capital and Liquidity Reform Package”. Bank for International Settlements, 2010.

———. "Recent Innovations in International Banking ", 1-270. Basel: Bank for International Settlements, 1986.

Black, J. *Rules and Regulators*. Oxford: Clarendon Press, 1997.

Blackett, Robert. "The Status of Religious "Courts" in UK Law" *Decisions, Decisions: Dispute Resolution & International Arbitration Newsletter* (2009): 11-19.

Blair, W., et al. *Banking and Financial Services Regulation*. Haywards Heath: Tottel Publishing, 2002.

Bloomberg. “Germany to Temporarily Bank Naked Short Selling, Some Swaps of Euro Bonds”. (2011). Available at: http://www.bloomberg.com/news/2010-05-18/germany-to-start-temporary-ban-on-naked-short-selling-of-euro-bonds-banks.html

Bourke, Patrick. "Dubai World Restructuring - the Legislation and How It May Work”. Norton Rose. (2009). Available at: http://www.lexology.com/library/detail.aspx?g=29592fe6-50c2-43b0-9e65-9d4e1964f69e

Bowen, John R. “How English Courts Recognize Shariah?”. In *University of St. Thomas Law Journal* 7 (2010): 411-435.

Braithwaite, John, and Peter Drahos. *Global Business Regulation.* Cambridge: Cambridge University Press, 2000.

Brown, Kevin. "Wider Appeal Battles with Signs of Inefficiency”. *Financial Times*, 2009.

Brunschvig, Robert. "Logic and Law in Classical Islam”. In *Logic in Classical Islamic Culture*, edited by G.E. von Grunebaum, 9-21. Wiesbaden: Otto Harrassowitz, 1970.

Burrough, Bryan. "Bringing Down Bear Stearns”. *Vanity Fair*, 2008, 1-16.

Çağatay, Neş'et. "Riba and Interest Concept and Banking in the Ottoman Empire”. *Studia Islamica* 32 (1970): 53-68.

Caruana, Jaime. "Basel III: Towards a Safer Financial System”. Paper presented at the 3rd Santander International Banking Conference, Madrid, 2010.

Cattan, Henry. "The Law of Waqf”. In *Law in the Middle East*, edited by Majid Khadduri and Herbert J. Liebesny, 203-23. Washington, D.C.: The Middle East Institute, 1955.

Chapra, M. Umer. "Islamic Economics: What It Is and How It Developed”. http://eh.net/encyclopedia/article/chapra.islamic: EH.Net Encyclopedia, 2005.

Chapra, M. Umer, and Tariqullah Khan. "Regulation and Supervision of Islamic Banks”. e-100. Jeddah: Islamic Development Bank, Islamic Research and Training Institute, 2000.

Chomsky, Noam. *Profit over People: Neoliberalism and Global Order*. New York: Seven Stories Press, 1998.

Chuah, Jason C.T. "Islamic Principles Governing International Trade Financing Instruments: A Study of the Morabaha in English Law”. *Northwestern Journal of International Law & Business* 27, no. 1 (2006-2007): 137-70.

Čihák, Martin, and Heiko Hesse. "Islamic Banks and Financial Stability: An Empirical Analysis”. In *IMF Working Paper*, 1-31. Washington, D.C.: International Monetary Fund, 2008.

CityUK, The. "Islamic Finance". (2011). Available at: http://www.thecityuk.com/assets/Uploads/Islamic-finance-2011.pdf.

Clancy, Patrick. "Legal Structure of Cash and Synthetic Transactions". In *Asset Securitisation and Synthetic Structures: Innovations in the European Credit Markets*, edited by Rick Watson and Jeremy Carter, 39-50. London: Euromoney, 2006.

Clode, Michael. "Regulatory Issues in Islamic Finance". In *Islamic Finance: Innovation and Growth*, edited by Simon Archer and Rifaat Ahmed Abdel Karim, 67-73. London: Euromoney Books, 2002.

Cohen, Hayyim. "The Economic Background and the Secular Occupations of Muslim Jurisprudents and Traditionists in the Classical Period of Islam". *Journal of the Economic and Social History of the Orient* 13 (1970): 16-62.

Collins, Lawrence, ed. *Dicey, Morris and Collins on the Conflicts of Laws*. Vol. II. London: Sweet & Maxwell, 2006.

Comair-Obeid, Nayla. *The Law of Business Contracts in the Arab Middle East*. London: Kluwer Law International, 1996.

Comaroff, Jean, and John L. Comaroff. "Millenium Capitalism: First Thoughts on a Second Coming". In *Millenial Capitalism and the Culture of Neoliberalism*, edited by Jean Comaroff and John L. Comaroff, 1-57. Durham: Duke University Press, 2001.

Commission, European. "Commission Staff Working Document". 1-9. Brussels: European Union, 2010.

Cotterrell, Roger. *Law's Community: Legal Theory in Sociological Perspective*. Oxford: Clarendon Press, 1995.

Coulson, Noel. *Commercial Law in the Gulf States*. London: Graham & Trotman, 1984.

———. "The Concept of Progress and Islamic Law". *Quest (Jan-Mar)* no. 40 (1964): 16-26.

Cox, Stella. "The Role of Capital Markets in Ensuring Islamic Financial Liquidity". In *Islamic Finance: The Regulatory Challenge*, edited by Simon Archer and Rifaat Ahmed Abdel Karim, 271-81. Singapore: John Wiley & Sons (Asia), 2007.

Crone, Patricia. *Meccan Trade and the Rise of Islam*. Oxford: Basil Blackwell, 1987.

———. *Roman, Provincial and Islamic Law*. Cambridge: Cambridge University Press, 1987.

Cunningham, Andrew. "Role of Sharia Boards Needs Modernisation". *Financial Times*, 2010. Available at: http://www.ft.com/cms/s/0/a5a6e474-4d54-11df-baf3-00144feab49a.html#axzz1WK1rhXTO

Davies, H., and D. Green. *Global Financial Regulation*. Cambridge: Polity Press, 2008.

Davies, Paul L., ed. *Gower and Davies' Principles of Modern Company Law*. 8th ed. London: Sweet & Maxwell, 2008.

DeLorenzo, Yusuf Talal. "Shari'a Supervision in Modern Islamic Finance". (2009). Available at: http://alhaqqsociety.wordpress.com/2010/01/04/yusuf-talal-delorenzo-shariah-supervision-in-modern-islamic-finance/

———. "Shari'ah Compliance Risk". *Chicago Journal of International Law* 7, no. 2 (2006-2007): 397-408.

DeLorenzo, Yusuf Talal, and Michael J.T. McMillen. "Law and Islamic Finance: An Interactive Analysis". In *Islamic Finance: The Regulatory Challenge*, edited by Simon Archer and Rifaat Ahmed Abdel Karim, 132-97. Singapore: John Wiley & Sons (Asia), 2007.

Deringer, Freshfields Bruckhaus. "Accidentally Alternative? Scope of the Alternative Finance Arrangements Provisions, Part II". (2008). Available at: http://www.freshfields.com/publications/pdfs/2008/feb04/accidentally_alternative_pt2.pdf.

Dictionary, Merriam-Webster's Online. "Custom". 2009.

Dien, Mawil Izzi. "Maslaha in Islamic Law: A Source of a Concept?". In *Studies in Honour of Clifford Edmund Bosworth*, edited by Ian Richard Netton, 345-57. Leiden: 2000.

DirectGov. "Budget March 2010 – Tax Changes". (2011). Available at: http://www.direct.gov.uk/en/Nl1/Newsroom/Budget/Budget2010/DG_186638

DiVanna, Joseph, and Antoine Sreih. *A New Financial Dawn: The Rise of Islamic Finance*. Cambridge: Leonardo and Francis Press, 2009.

Dockey, D.S., M. Hirschey, and E. Jones. "Information and Contagion Effects of Bank Loan-Loss Reserve Announcements". *Journal of Financial Economics* 43, no. 2 (1997): 219-40.

Dusuki, Asyraf Wajdi. "Commodity Murabahah Programme (CMP): An Innovative Approach to Liquidity Management". In *Essential Readings in Islamic Finance*, edited by Mohd Daud Bakar and Engku Adawiah Engku Ali, 171-90. Kuala Lumpur: CERT, Centre for Research and Training, 2008.

Dworkin, Ronald. "Liberalism". In *Public and Private Morality*, edited by Stuart Hampshire, 113-43. London: Cambridge University Press, 1978.

Eaglesham, Jean. "Vision Focuses on Fairness and Firmness". *Financial Times*, 2010.

Eatwell, John, and Lance Taylor. *Global Finance at Risk*. Cambridge: Polity Press, 2000.

Edwardes, Warren. *Key Financial Instruments: Understanding and Innovating in the World of Derivatives*. London: Pearson Education Limited, 2000.

Eedle, Simon. "A Global Bank's View of the Evolution of Islamic Finance". *Islamic Finance Review, Euromoney Yearbooks* (2009-2010): 1-4.

Egypt, Arab Republic of. "Constitutional Declaration". 1-14. Cairo: Supreme Council of Armed Forces, 2011. Available at: http://www.cabinet.gov.eg/AboutEgypt/ConstitutionalDeclaration_e.pdf

El-Diwany, Tarek. *The Problem with Interest*. 2nd ed. London: Kreatoc, 2003.

———. *Islamic Banking and Finance: What It Is and What It Could Be*. Edited by Tarek El Diwany. Bolton 1st Ethical Charitable Trust, 2010.

El-Gamal, Mahmoud A. *Islamic Finance: Law, Economics, and Practice*. Cambridge: Cambridge University Press, 2006.

———."An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence". 1-28. Houston: Rice University, 2001.

———. "An Economic Explication of the Prohibition of Riba in Classical Islamic Jurisprudence". 1-20. Houston: Rice University, 2001.

———. "Interest and the Paradox of Contemporary Islamic Law and Finance". *Fordham International Law Journal* 27 (2003-2004): 108-49.

———. "An Introduction to Modern Islamic Economics and Finance". Paper Presented at the Fourth Harvard University Forum on Islamic Finance. Islamic finance: The task ahead, Cambridge, 2000.

———. *Islamic Finance: Law, Economics, and Practice*. Cambridge: Cambridge University Press, 2006.

El-Hawary, D., W. Grais, and Z. Iqbal. "Regulating Islamic Financial Institutions: The Nature of the Regulated". In *World Bank Policy Research Working Paper*, 1-49. Washington, D.C.: The World Bank, 2004.

Ellinger, E.P., Eva Lomnicka, and Richard Hooley. *Ellinger's Modern Banking Law*. Oxford: Oxford University Press, 2006.

Engku Rabiah Adawiah Engku, Ali. "Issues in Islamic Debt Securitization" In *Essential Readings in Islamic Finance*, edited by Mohd Daud Bakar and Ali Engku Rabiah Adawiah Engku, 443-93. Kuala Lumpur: CERT, 2008

EC (European Council). "Summary: Unfair Terms in Consumer Contracts". (1993). Available at: http://europa.eu/legislation_summaries/consumers/protection_of_consumers/l32017_en.htm.

Euromoney. "Islamic Finance Debate: Prospects and Problems of Shari'ah-Compliant Finance". (2008). Available at: http://www.euromoney.com/Article/2060693/Islamic-finance-debate-Prospects-and-problems-of-Shariah-compliant-finance.html.

Exchange, Bahrain Financial. "The Exchange Business: An Insight". (2010). Available at: http://www.bfx.bh/Media/Download/BFXExchangeHandbook1.pdf.

Fadlallah, Ibrahim. "Arbitration Facing Conflicts of Culture: The 2008 Annual School of International Arbitration Lecture Sponsored by Freshfields Bruckhaus Deringer LLP". *Arbitration International* 25, no. 3 (2009): 303-19.

Fazio, Silvia. *The Harmonization of International Commercial Law*. Alphen aan den Rijn: Kluwer Law International, 2007.

Feldman, David. *Civil Liberties and Human Rights in England and Wales*. 2nd ed. Oxford: Oxford University Press, 2002.

———, ed. *Oxford Principles of English Law: English Public Law*. 2nd ed. Oxford: Oxford University Press, 2009.

Fiennes, Toby. "Supervisory Implications of Islamic Banking: A Supervisor's Perspective". In *Islamic Finance: The Regulatory Challenge*, edited by Simon Archer and Rifaat Ahmed Abdel Karim, 247-56. Singapore: John Wiley & Sons (Asia), 2007.

Fisher, Irving. *100% Money*. New York: Adelphi Company, 1936.

Forum, Joint. "Risk Management Practices and Regulatory Capital: Cross Sectoral Comparison". 1-126. Basel: Basel Committee Joint Publication, 2001.

Foster, Nicholas H.D. "Transfer of Rights and Obligations in the UAE: A Comparative Analysis in the Light of English Law, French Law and the Shari'a". *Yearbook of Islamic and Middle Eastern Law* 7 (2000-2001): 3-70.

———. "Foundation Myth as Legal Formant: The Medieval Law Merchant and the New Lex Mercatoria", *Forum Historiae Juris* (2005). Available at: http://www.forhistiur.de/zitat/0503foster.htm.

———. "Comparative Commercial Law: Rules or Context" In: *Comparative Legal Studies: A Handbook,* edited by David Nelken and Esin Örücü, 263-285. Oxford: Hart Publishing, 2007.

———. "Islamic Finance Law as an Emergent Legal System". *Arab Law Quarterly* 21, no. 2 (2007): 170-88.

———. "Islamic Perspectives on the Law of Business Organisations II: The Sharia and Western-Style Business Organisations". *European Business Organization Law Review* 11 (2010): 273-307.

———. "Using Comparative Commercial Law in the Study of Legal Transformation: Commercial Aspects of the Early Stages of Ottoman Legal Transition". In *Islamic Law Facing the Challenges of the 21st Century*, edited by Ron Shaham and Aharon Layish, forthcoming 2011.

Freshfields, Bruckhaus, Deringer. "The New Regulatory Architecture: The Changing Role of the FSA". 1-4. London: Freshfields Bruckhaus Deringer, 2009.

Fry, Maxwell J. *Emancipating the Banking System and Developing Markets for Government Debt*. New York: Routledge, 1997.

FSA (Financial Services Authority). "UK Implementation of the New Basel and EU Capital Adequacy Standards". 1-40. London: Financial Services Authority, 2002.

———. "Strengthening Liquidity Standards". 1-166. London: Financial Services Authority, 2008.

———. "The Fit and Proper Test for Approved Persons (FIT)". In *FSA Handbook*. London: Financial Services Authority, 2011. Available at: http://www.fsahandbook.info/FSA/html/handbook/FIT

FSA & Treasury, Her Majesty's. "Consultation on the Legislative Framework for the Regulation of Alternative Finance Investment Bonds (Sukuk)". 1-36. London: Financial Services Authority, 2008.

FSCS (Financial Services Compensation Scheme). "Compensation Limits". Financial Services Compensation Scheme. (2010). Available at: http://www.fscs.org.uk/what-we-cover/eligibility-rules/compensation-limits/

Furneaux, Paul, Samer Hijazi, John Lee, and Jamal Fakhro. "Cross-Border Development in Islamic Banking". *Euromoney Yearbooks* Islamic Finance Review (2008/09): 44-48.

Geertz, Clifford. *Local Knowledge: Further Essays in Interpretive Anthropology*. Basic Books, 1983.

Giddens, Anthony. *The Consequences of Modernity*. Stanford Polity Press, 1990.

Globe, The Islamic. "S&P: Record High Sukuk Issuance 2010". (2010). Available at: http://www.theislamicglobe.com/index.php?option=com_content&view=article&id=112:sap-record-high-sukuk-issuance-2010&catid=6:article&Itemid=38.

Gluckman, Max. *The Judicial Process among the Barotse of Northern Rhodesia*. Manchester: University of Manchester Press, 1955.

Goetzmann, William N., and K. Geert Rouwenhorst. "Financial Innovations in History". In *The Origins of Value: The Financial Innovations That Created Modern Capital Markets*, edited by William N. Goetzmann and K. Geert Rouwenhorst, 3-17. Oxford: Oxford University Press, 2005.

Goitein, S.D. "The Birth-Hour of Muslim Law? An Essay in Exegesis". *Muslim World* 50 (1960): 23-29.

———. "The Cairo Geniza as a Source for the History of Muslim Civilisation". *Studia Islamica* 3 (1955): 75-91.

———. "Commercial and Family Partnerships in the Countries of Medieval Islam". *Islamic Studies* III (1964): 315-39.

———. *A Mediterranean Society*. Vol. I Economic Foundations. Berkeley: University of California Press, 1967.

Goldberg, David, and Elspeth Attwooll. "Legal Orders, Systemic Relationships and Cultural Characteristics: Towards Spectral Jurisprudence". In *Studies in Legal Systems: Mixed and Mixing*, edited by Esin Örücü, Elspeth Attwooll and Sean Coyle, 313-35. The Hague: Kluwer Law International, 1996.

Goldziher, Ignaz. "Muhammedanisches Recht in Theorie Und Wirklichkeit". *Zeitschrift fuer vergleichende Rechtswissenschaft* viii (1888): 406-23.

Goode, Roy. *Commercial Law*. Third ed. London: Penguin Group, 2004.

———. *Commercial Law in the Next Millenium*. London: Sweet & Maxwell, 1998.

———. *Goode on Commercial Law*. Edited by Ewan McKendrick. 4th ed. London: Penguin Books, 2010.

Goode, Roy, Herbert Kronke, and Ewan McKendrick. *Transnational Commercial Law*. Oxford: Oxford University Press, 2007.

Goodhart, C., P. Hartmann, D. Llewellyn, and et al. *Financial Regulation: Why, How and Where Now?* London: Routledge, 1998.

Grais, Wafik, and Matteo Pellegrini. "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options". In *World Bank Policy Research Working Paper*, 1-46. Washington, D.C.: The World Bank, 2006.

Grais, Wafik, and Matteo Pellegrini. "Corporate Governance and Sharia Compliance in Institutions Offering Islamic Financial Services". In *World Bank Policy Research Working Paper 4054,* 1-38. Washington, D.C.: The World Bank, 2006.

Gray, Robert, and Arshad Ismail. "Regulating Islamic Capital Markets". In *Islamic Finance: The Reglatory Challenge*, edited by Simon Archer and Rifaat Ahmed, 282-91. Singapore: John Wiley & Sons (Asia), 2007.

Greif, Avner. "Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders". *Journal of Economic History* 49, no. 4 (1989): 857-82.

Greuning, Hennie van, and Zamir Iqbal. "Banking and the Risk Environment". In *Islamic Finance: The Regulatory Challenge*, edited by Simon Archer and Rifaat Ahmed Abdel Karim, 11-39. Singapore: John Wiley & Sons (Asia), 2007.

———. *Risk Analysis for Islamic Banks*. Washington, D.C.: The World Bank, 2008.

Haldane, Andrew. Control Rights (and Wrongs). In Wincott Annual Memorial Lecture. 1-29: Bank of England, 2011. Available at: http://www.bankofengland.co.uk/publications/speeches/2011/speech525.pdf

Hallaq, Wael B. *Authority, Continuity, and Change in Islamic Law*. Cambridge: Cambridge University Press, 2001.

———. *An Introduction to Islamic Law*. Cambridge: Cambridge University Press, 2009.

———. *Islamic Legal Theories*. Cambridge: Cambridge University Press, 1997.

———. *Shari'a: Theory, Practice, Transformations*. Cambridge: Cambridge University Press, 2009.

———. "Was the Gate of Ijtihad Closed?" *International Journal of Middle East Studies* 16, no. 1 (1984): 3-41.

———. "Contracts and Alliances". In *Encyclopedia of the Qur'an*, 1-4: Brill Online, 2008.

Hammond, Ed. "Investors Transform UK Horizon". *Financial Times*, 2011. Available at: http://www.ft.com/cms/s/0/3dbd26fe-7aa1-11e0-8762-00144feabdc0.html#axzz1WKYWWLm7

Hamoudi, Haider Ala. "Jurisprudential Schizophrenia: On Form and Function in Islamic Finance". *Chicago Journal of International Law* 7 (2006-2007): 605-22.

———. "The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law". *American Journal of Comparative Law* 56 (2008): 423-70.

———. "Muhammad's Social Justice or Muslim Cant?: Langdellianism and the Failures of Islamic Finance". *Cornell International Law Journal* 89 (2007): 89-134.

———. "You Say You Want a Revolution: Interpretive Communities and the Origins of Islamic Finance". *Virginia Journal of International Law* 48 (2007-2008): 249-305.

———. “The Death of Islamic Law”. *Georgia Journal of International and Comparative Law* 38 (2010): 293-305.

Haneef, Mohammed Rafe Md. "Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities”. Paper presented at Harvard University Forum on Islamic Finance. Islamic Finance: Current Legal and Regulatory Challenges, Cambridge, 2005.

Haque, Ziaul. *Islam and Feudalism: The Economics of Riba, Interest and Profit*. Lahore: Vanguard Books, 1985.

Hardy, Nicholas. "Shari'a Compliance: Understanding the Contributions of Shari'a Boards”. In *Beitraege Zum Islamischen Recht*, edited by Irene Schneider and Thoralf Hanstein, 199-225. Frankfurt am Main: Peter Lang Verlag, 2006.

Härle, Philipp, Matthias Heuser, Sonja Pfetsch, and Thomas Poppensieker. "Basel III: What the Draft Proposals Might Mean for European Banking”. 1-16: McKinsey & Company, 2010.

Harvey, David. *A Brief History of Neoliberalism*. Oxford: Oxford University Press, 2005.

———. *The Condition of Postmodernity*. Malden: Blackwell, 1990.

Hasan, Aznan. "An Introduction to Collective Ijtihad”. *The American Journal of Islamic Social Sciences* 20, no. 2: 26-49, (n.d.). Available at: http://i-epistemology.net/attachments/709_Ajiss20-2%20-%20Hasan%20-%20An%20Introduction%20to%20Collective%20Ijtihad.pdf.

Hassan, Hussein. “Contracts in Islamic Law: The Principles of Commutative Justice and Liberality”. Journal of Islamic Studies 13, no. 3 (2002): 257-297.

Hegazy, Walid. "Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets”. Paper presented at the Harvard University Forum on Islamic Finance. Islamic Finance: Current Legal and Regulatory Issues, Cambridge, 2005.

Henry, Clement M. "Islamic Finance in the Dialectics of Globalisation: Potential Variations on the 'Washington Consensus'“. In *The Economy and the Law*, edited by Shahram Akbarzadeh, 143-59. New York: Routledge, 2006.

Herring, R. , and T. Shuermann. "Capital Regulation for Position Risk in Banks, Securities Firms, and Insurance Companies”. In *Capital Adequacy Beyond Basel: Banking, Securities, and Insurance*, edited by H.S. Scott. New York: Oxford University Press, 2005.

Hijazi, Faizal. "Global Sukuk Issuance: 2008 Slowdown Mainly Due to Credit Crisis, but Some Impact from Shari'ah Compliance Issues". (2009). Available at: *http://www.institutfrancaisdefinanceislamique.fr/docs/docs/doc_id57.pdf*.

Hill, Mark, and Russell Sandberg. "Is Nothing Sacred? Clashing Symbols in a Secular World". *Public Law*, no. Autumn (2007): 488-507.

HMRC (Her Majesty's Revenue and Customs). "Impact Assessment for Stamp Duty Land Tax, Capital Gains Tax & Capital Allowance Tax Reliefs for Alternative Finance Investment Bonds". 1-10. London: HM Revenue & Customs, 2009.

———. "Impact Assessment of Sukuk (Islamic Bonds) Legislation". 1-9. London: HM Revenue & Customs, 2008.

———. "Stamp Duty Land Tax: Commercial Sukuk". 1-24. London: HM Revenue & Customs, 2008.

———. "Stamp Duty Land Tax: Commercial Sukuk: A Response to the Consultation". 1-13. London: HM Revenue & Customs, 2009.

———. "Stamp Duty Land Tax (Alternative Finance Investment Bonds) Regulations 2010", 2010, S.I. No. 184.

Hodgson, Marshall G.S. *The Venture of Islam*. Vol. I. Chicago: The University of Chicago Press, 1961.

Hohfeld, WN. "Fundamental Legal Conceptions as Applied in Judicial Reasoning". *Yale Law Journal* 27 (1916-1917): 710-70.

———. "Some Fundamental Legal Conceptions as Applied in Judicial Reasoning". *Yale Law Journal* 23 (1913-1914): 16-59.

Horii, Satoe. "Reconsideration of Legal Devices (Hiyal) in Islamic Jurisprudence: The Hanafis and Their "Exits" (Makharij)". *Islamic Law and Society* 9, no. 3 (2002): 312-57.

Horowitz, Donald L. "The Qur'an and the Common Law: Islamic Law Reform and the Theory of Legal Change, Part I". *American Journal of Comparative Law* 42 (1994): 233-95.

———. "The Qur' an and the Common Law: Islamic Law Reform and the Theory of Legal Change, Part II". *American Journal of Comparative Law* 42, no. 3 (1994): 543-81.

Hourani, Albert. *Arabic Thought in the Liberal Age*. Cambridge: Cambridge University Press, 1984.

Hourani, Husam, and Rima Fahl. "Securities Law in the United Arab Emirates" *Arab Law Quarterly* 16, no. 1 (2001): 55-61.

Housby, Elaine. "The Development of the Islamic Financial Tradition in Contemporary Britain". Open University, Ph.D. Thesis, 2005.

Howells, Peter, and Keith Bain. *Financial Markets and Institutions*. 5th ed. Harlow: Pearson Education Limited, 2007.

Howladar, Khalid, Paul Marty, and Moody's Investor Service. "Sukuk Credit Ratings: Key Risk Drivers". In *Islamic Finance Review, Euromoney Yearbooks*, edited by Lori Nicholson, 26-31. Colchester: Adrian Hornbrook, 2006-2007.

Hurgronje, C. Snouck. *"Islamic Law and Custom" in Selected Works*. Edited by G.H. Bousquet and J. Schacht, Selected Works. Leiden: E.J. Brill, 1957.

IBB (Islamic Bank of Britain). "Annual Report and Financial Statements". 1-44. London: Islamic Bank of Britain, 2009.

———. "Articles of Association of the Islamic Bank of Britain". 1-82. London: Islamic Bank of Britain, 2008.

———. "Business Finance". 1-2. London: Islamic Bank of Britain, 2006.

———. "Consumer Banking: Terms and Conditions". London: Islamic Bank of Britain, 2011. Available at: http://www.islamic-bank.com

IFSB (Islamic Financial Services Board). "Capital Adequacy Standard for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services". 1-71. Kuala Lumpur: IFSB, 2005. Available at: http://www.ifsb.org/standard/ifsb2.pdf

———."Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)". 1-33. Kuala Lumpur: IFSB, 2006. Available at: http://www.ifsb.org/standard/ifsb3.pdf

———."Capital Adequacy Requirements for Sukuk, Securitisations and Real Estate Investment". (2009). Available at: http://www.ifsb.org/standard/ifsb7.pdf, 2009.

IFSL (International Financial Services London). "Islamic Finance 2010". 1-8. London: International Financial Services London, 2010.

IIFM (International Islamic Financial Market). "Sukuk Report: A Comprehensive Study of the International Sukuk Market". (2010). Available at: http://www.institutfrancaisdefinanceislamique.fr/docs/files/14_IIFM_Sukuk__Report_1st_Edition.pdf.

Ingham, Geoffrey. *The Nature of Money*. Cambridge: Polity Press, 2004.

IOSCO (International Organization of Securities Commissions). "Analysis of the Application of Iosco's Objectives and Principles of Securities Regulation for Islamic Securities Products". 1-43: Executive Committee of the International Organization of Securities Commissions, 2008.

Isard, Peter. *Globalization and the International Financial System*. Cambridge: Cambridge University Press, 2005.

Jackson, Sherman. "Fiction and Formalism: Toward a Functional Analysis of Usul Al-Fiqh". In *Studies in Islamic Legal Theory*, edited by Bernard Weiss, 177-201. Leiden: Brill, 2002.

———. *Islamic Law and the State: The Constitutional Jurisprudence of Shihab Al-Din Al-Qarafi*. Leiden: E.J. Brill, 1996.

Jarrar, Khalil. "Enforcing Arbitral Awards in Islamic Finance Contracts". *Opalesque Islamic Finance Intelligence, Lex Islamicus*, no. 4 (2009): 12-13.

Jennings, Ronald C. "Loans and Credit in Early 17th Century Ottoman Judicial Records: The Sharia Court of Anatolian Kayseri". *Journal of the Economic and Social History of the Orient* 16, no. 2/3 (1973): 168-216.

Jobst, Andreas. "The Economics of Islamic Finance and Securitization". In *IMF Working Paper*, 1-35. Washington, D.C.: International Monetary Fund, 2007.

Jobst, Andreas, Peter Kunzel, Paul Mills, and Amadou Sy. "Islamic Bond Issuance - What Sovereign Debt Managers Need to Know". In *IMF Policy Discussion Paper*, 1-22. Washington, D.C.: International Monetary Fund, 2008.

Johansen, Baber. *Contingency in a Sacred Law: Legal and Ethical Norms in the Muslim Fiqh*. Edited by Ruud Peters and Bernard Weiss. Vol. 7, Studies in Islamic Law and Society. Leiden: Brill, 1999.

———. "Die Sündige, Gesunde Amme. Moral Und Gesetzliche Bestimmung (Hukm) Im Islamischen Recht". *Die Welt des Islams* XXVIII (1988): 264-82.

Johnston, David L. "Maqasid Al-Shari'a: Epistemology and Hermeneutics of Muslim Theologies of Human Rights" *Die Welt des Islams* 47, no. 2 (2007): 149-87.

Junius, Andreas. "Islamic Finance: Issues Surrounding Islamic Law as a Choice of Law under German Conflict of Laws Principles". *Chicago Journal of International Law* 7, no. 2 (2007): 537-50.

Justice, UK Ministry of. "Rome 1 - Should the UK Opt In?", 1-136. London: Ministry of Justice, 2008.

Juynboll, Th. W. *Handbuch Des Islamischen Gesetzes*. Leipzig: Otto Harassowitz, 1910.

Kahf, Monzer. "Islamic Banks: The Rise of a New Power Alliance of Wealth and Shari'a Scholarship". In *The Politics of Islamic Finance*, edited by Clement M. Henry and Rodney Wilson, 17-37. Edinburgh: Edinburgh University Press, 2004.

Kamali, Mohammad Hashim. *Islamic Commercial Law*. Cambridge: Islamic Texts Society, 2000.

———. *Principles of Islamic Jurisprudence*. Cambridge, UK: Islamic Texts Society, 2003.

Karasik, Theodore, Frederic Wehrey, and Steven Strom. "Islamic Finance in a Global Context: Opportunities and Challenges". *Chicago Journal of International Law* 7, no. 2 (2007): 379-96.

Kay, John. "The Forms of Regulation". In *Regulation or over-Regulation?*, edited by A. Seldon. London: Institute of Economic Affairs, 1988.

Kettel, Brian. *Introduction to Islamic Banking & Finance*. London: Islamic Banking Training, 2008.

Khan, Muhammad Muhsin. "The Translation of the Meanings of Sahih Al-Bukhari". Hilal Yayinlari, n.d.

Khan, Shujaat A. "Two Paths to Development: Capitalist vs. Islamic Approach". In *Islamic Banking and Finance*, edited by Amer Al-Roubaie and Shafiq Alvi, 22-35. London: Routledge, 2010.

Khatchadourian, Minas. "Arbitration and Mediation between Europe and the Gulf". 1-18. Sharm El-Sheikh: Sharm El-Sheikh International Arbitration Center, 2010.

Khoury, Nabil A. *Islam and Modernisation in the Middle East: Muhammad 'Abduh, an Ideology of Development, a Doctoral Dissertation*. Albany: State University of New York, 1976.

Koendgen, Johannes. "Regulation of Banking Services in the European Union: A Comparative View". In *Economic Regulation and Competition*, edited by Juergen Basedow, Harald Baum, Klaus J. Hopt, Hideki Kanda and Toshiyuki Kono, 27-74. The Hague: Kluwer Law International, 2002.

Kopytoff, Igor. "The Cultural Biography of Things: Commoditization as Process". In *The Social Life of Things*, edited by Arjun Appadurai, 64-95. Cambridge: Cambridge University Press, 1986.

Kourides, P. Nicholas. "The Influence of Islamic Law on Contemporary Middle Eastern Legal Systems: The Formation and Binding Force of Contracts". *Columbia Journal of Transnational Law* 9 (1970): 384-435.

Krawietz, Birgit. "Cut and Paste in Legal Rules: Designing Islamic Norms with Talfiq". *Die Welt des Islams* 42 (2002).

Kuran, Timur. "The Discontents of Islamic Morality". *The American Economic Review* 86, no. 2 (1996): 438-42.

———. *Islam and Mammon: The Economic Predicaments of Islamism*. Oxford: Princeton University Press, 2004.

———. "Islamic Economics and the Islamic Subeconomy". *Journal of Economic Perspectives* 9, no. 4 (1995): 155-73.

———. *The Long Divergence: How Islamic Law Held Back the Middle East*. Princeton: Princeton University Press, 2011.

Labib, Sobhi. "Geld Und Kredit: Studien Zur Wirtschaftsgeschichte Aegyptens Im Mittelalter". *Journal of the Economic and Social History of the Orient* II (1959): 225-47.

Lanchester, John. Whoops: Why Everyone Owes Everyone And No One Can Pay. London: Allen Lane, 2010.

Langholm, Odd. *The Aristotelian Analysis of Usury*. Bergen: Universitetsforlaget, 1984.

Larosiere, Jacques de. "Basel Rules Risk Punishing the Wrong Banks". *Financial Times*, 2010.

Layish, Aharon. "The Contribution of the Modernists to the Secularisation of Islamic Law". *Middle Eastern Studies* 14, no. 3 (1978): 263-78.

Leff, Arthur Allen. "Economic Analysis of the Law: Some Realism About Nominalism". *Virginia Law Review* 60 (1974): 451-82.

Levy, Juliette. "Under Duress". *New Law Journal* 156, no. 7228 (2006).

Lewis, Mervyn K., and Latifa M. Algaoud. *Islamic Banking*. Cheltenham: Edward Elgar, 2001.

Libson, Gideon. "On the Development of Custom as a Source of Law in Islamic Law". *Islamic Law and Society* 4, no. 2 (1997): 131-55.

Linklaters. "Recent Developments in Enforcement of Arbitral Awards in the United Arab Emirates". (2011). Available at: http://www.linklaters.com/Publications/GCC/May/Pages/Recent_Developments_Enforcement_Arbitral_Awards_United_Arab_Emirates.aspx.

Llewellyn, D. "The Economic Rationale for Financial Regulation". In *FSA Occasional Papers in Financial Regulation*, 1-58. London: Financial Services Authority, 1999.

———. "Regulation of Retail Investment Services". *Economic Affairs* 15, no. 2 (1995): 1-12.

———. "Universal Banking and the Public Interest: A British Perspective". In *Universal Banking: Financial System Design Reconsidered*, edited by Anthony Saunders and Ingo Walter. Chicago: Irwin Professional Publishing, 1996.

LMC (Liquidity Management Centre). "Vision & Role". (2011). Available at: http://www.lmcbahrain.com/role.asp.

London, City of. "Global Financial Centres 7". 1-41. London: City of London, 2010. Available at: http://www.zyen.com/PDF/GFC%207.pdf

Lopez, Robert S., and Irving W. Raymond. *Medieval Trade in the Mediterranean World: Illustrative Documents*. London: Oxford University Press, 1955.

LSE (London Stock Exhange). "Islamic Factsheet". (2010). Available at: *http://www.londonstockexchange.com/specialist-issuers/islamic/downloads/london-a-global-hub-for-islamic-finance.pdf*.

Luhmann, Niklas. *Social Systems*. Standford: Stanford University Press, 1995.

———. *Soziologische Aufklaerung 3*. 2 ed. Opladen: Westdeutscher Verlag GmbH, 1991.

———. *Soziologische Aufklaerung: Aufsaetze Zur Theorie Sozialer Systeme*. Koeln und Opladen: Westdeutscher Verlag GmbH, 1970.

Macaulay, Stewart. "Non-Contractual Relations in Business: A Preliminary Study". *American Sociological Review* 28, no. 1 (1963): 55-67.

Maine, Henry Sumner. *Ancient Law: Its Connection with the Early History of Society and Its Relation to Modern Ideas*. 10th ed. London: John Murray, 1885.

Makdisi, John. "The Islamic Origins of the Common Law". *North Carolina Law Review* 77, no. 5 (1998-99): 1635-738.

Malaysia, Securities Commission, and Syariah Advisory Council. "Resolution: Bai' Dayn". (2011). Available at: http://www.sc.com.my/main.asp?pageid=450&menuid=554&newsid=&linkid=&type=#BD .

Malik, Maleiha. "Faith and the State of Jurisprudence". In *Faith in Law: Essays in Legal Theory*, edited by Peter Oliver, Sionaidh Douglas Scott and Victor Tadors, 129-51. Oxford: Hart Publishing, 2000.

Mallat, Chibli. "Commercial Law in the Middle East: Between Classical Transactions and Modern Business". *The American Journal of Comparative Law* 48, no. 1 (2000): 81-141.

———. "The Debate on Riba and Interest in Twentieth Century Jurisprudence". In *Islamic Law and Finance*, edited by Chibli Mallat. London: School of African and Oriental Studies, 1988.

———. "From Islamic to Middle Eastern Law: A Restatement of the Field (Part I)". *American Journal of Comparative Law* 51, no. 4 (2003): 699-750.

Mann, F.A. *The Legal Aspect of Money*. 5th edition ed. Oxford: Oxford University Press, 2003.

Masmoudi, Farid, and Tarik Belabed. "Islamic Finance in the Face of the Financial Turmoil: Opportunities and Challenges". In *http://www.capnouveaumonde.org/capmena/pdf/20100303%20Masmoudi%20&%20Belabed%20(eng).pdf*, 1-6: CapMena, 2010.

Masters, Brooke. "Stability Is Key in Reform Blueprint". *Financial Times*, 2010.

Maurer, Bill. *Mutual Life, Limited: Islamic Banking, Alternative Currencies, Lateral Reason*. Princeton: Princeton University Press, 2005.

Mayer, Ann. "The Shari'ah: A Methodology or a Body of Substantive Rules?". In *Islamic Law and Jurisprudence*, edited by Nicholas Heer, 177-198. Seattle: University of Washington Press, 1990.

MCB (Muslim Council of Britain). "Islamic Finance Transparency Standard: A Consultation". 1-16. London: The Muslim Council of Britain, 2008. Available at: http://www.mcb.org.uk/uploads/MCBIslamicFinanceTransparencyStandard.pdf

McMillen, Michael J.T. "Sukuk Issuance and the Glimpse of a Secondary Market". *Euromoney Yearbooks* Islamic Finance Review (2006/2007): 10-17.

Meadows, Pamela. "Access to Financial Services". London: National Institute of Economic and Social Research, 2000.

Melchert, Christopher. "The Formation of the Sunni Schools of Law". In *The Formation of Islamic Law*, edited by Wael B. Hallaq, 351-67. Aldershot: Ashgate, 2004.

Menski, Werner. *Comparative Law in a Global Context: The Legal Systems of Asia and Africa*. Cambridge: Cambridge University Press, 2006.

Merry, Sally Engle. "Legal Pluralism". *Law and Society Review* 22 (1988): 869-96.

Meyer, John W., John Boli, and George M. Thomas. "Ontology and Rationalization in the Western Cultural Account". In *Institutional Structure: Constituting State, Society, and the Individual*, edited by John W. Meyer, John Boli and George M. Thomas, 11-39. Newbury Park: Sage Publications, 1987.

Michaels, Ralf. "The True Lex Mercatoria: Private Law Beyond the State " *Indiana Journal of Global Legal Studies* 14, no. 2 (2007): 447-68.

Mishkin, Frederic S. *The Economics of Money, Banking, and Financial Markets*. Boston: Pearson, Addison Wesley, 2004.

Moghul, Umar F., and Arshad A. Ahmed. "Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors.: A First

Impression of Islamic Finance". *Fordham International Law Journal* 27, no. 1 (2003-2004): 150-94.

Montanaro, Elisabetta. "Islamic Banking: A Challenge for the Basel Capital Accord". In *Islamic Banking and Finance in the European Union*, edited by M. Fahim Khan and Mario Porzio, 112-28. Cheltenham: Edward Elgar, 2010.

Moore, Sally Falk. *Law as Process*. London:Routledge & Kegan Paul, 1978.

Muchlinski, Peter T. "'Global Bukowina' Examined: Viewing the Multinational Enterprise as a Transnational Law-Making Community". In *Global Law without a State*, edited by Gunther Teubner, 79-109. Aldershot: Dartmouth Publishing Company, 1997.

———. *Multinational Enterprises & the Law*. Oxford: Oxford University Press, 2007.

Muegge, Daniel. "Reordering the Marketplace: Competition Politics in European Finance". *Garnet Working Paper*, no. 05/06 (2006): 1-34.

Murray-Brown, John and Neil Dennis. "Ireland Guarantees Six Banks' Deposits". *Financial Times.* London: 2008. Available at: http://www.ft.com/cms/s/0/2124f8f4-8eb9-11dd-946c-0000779fd18c.html3#axzz1XkWOA76T

Musa, Muhammad Yusuf. "The Liberty of the Individual in Contracts and Conditions According to Islamic Law". *Islamic Quarterly* II, no. 2 (1955): 79-86.

Mwenda, M. *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator*. Washington, D.C.: The World Bank, 2006.

Nadkarni, Avadhoot. "World Trade Liberalisation: National Autonomy and Global Regulation". In *Global Instability*, edited by Jonathan Mitchie and John Grieve Smith, 134-51. London: Routledge, 1999.

Nakheel Development Limited. "Offering Circular". (2006). Available at: http://blogs.thenational.ae/economy_blog/Nakheel%20Development%201%20Prospectus.pdf

News, Out-Law. "UK Signs up to Rome I Rules on Cross-Border Contract Disputes". (2008). Available at: http://www.out-law.com/page-9337

Nielsen, Jorgen. *Muslims in Western Europe*. Edited by Carole Hillenbrand, The New Edinburgh Islamic Surveys. Edinburgh: Edinburgh University Press, 2004.

Noibi, Mansur. "Prudential Regulation of Islamic Banks". In *Islamic Banking and Finance*, edited by Amer Al-Roubaie and Shafiq Alvi, 180-94. London: Routledge, 2010.

NS&I (National Savings & Investment). "Shari'a Compliant Savings Review". 1-22. London: National Savings & Investments, 2008.

Nyazee, Imran Ahsan Khan. *Islamic Law of Business Organization: Partnerships*. Islamabad: The International Institute of Islamic Thought and Islamic Research Institute, 1997.

O'Brien, Robert, and Marc Williams. *Global Political Economy*. 3rd ed. Basingstoke: Palgrave MacMillan, 2010.

Oakley, David. "London Leads in Race to Be Western Hub". *Financial Times*, 2009.

Ogus, A.I. *Regulation: Legal Form and Economic Theory*. Oxford: Hart Publishing, 2004.

Opwis, Felicitas. "Islamic Law and Legal Change: The Concept of Maslaha in Classical and Contemporary Islamic Legal Theory". In *Shari'a: Islamic Law in the Contemporary Context,* edited by Abbas Amanat and Frank Griffel, 62-83. Stanford: Stanford University Press, 2007.

———. "Maslaha in Contemporary Legal Theory". *Islamic Law and Society* 12, no. ii (2005): 182-223.

Örücü, Esin. "Mixed and Mixing Systems: A Conceptual Search". In *Studies in Legal Systems: Mixed and Mixing*, edited by Esin Örücü, Elspeth Attwooll and Sean Coyle, 335-52. The Hague: Kluwer Law International, 1996.

Palmer, Vernon Valentine. "From Lerotholi to Lando: Some Examples of Comparative Law Methodology". *The American Journal of Comparative Law* 53, no. 1 (2005): 261-90.

Parker, George, and Brooke Masters. "FSA to Be Abolished in Osborne Shake-Up". *Financial Times*, 17 June 2010 2010.

Parker, Mushtak. "Islamic Bank Enters Germany". http://www.arabnews.com/economy/islamicfinance/article47229.ece.

———. "Islamic Finance Gaining Major Support in Britain". (2010). Available at: http://archive.arabnews.com/?page=6&section=0&article=132209&d=1&m=2&y=2010

Parry, Jonathan, and Maurice Bloch. "Money and the Morality of Exchange". In *Money and the Morality of Exchange*, edited by Jonathan Parry and Maurice Bloch, 1-33. Cambridge: Cambridge University Press, 1989.

Pelaez, Carlos M., and Carlos A. Pelaez. *Financial Regulation after the Global Recession*. Basingstoke: Palgrave Macmillan, 2009.

Peters, Ruud. "From Jurists' Law to Statute Law or What Happens When the Shari'a is Codified". *Mediterranean Politics* 7, no. 3 (2002): 82-95.

Pettit, Philip H. *Equity and the Law of Trusts*. 7th Edition ed. London: Butterworths, 1993.

Photo Production Ltd V Securicor Transport Ltd. Appelants, 1980 A.C. 827.

Posner, Eric A. *Law and Economics*. Aldershot Ashgate/Dartmouth, 2001.

Posner, Richard A. "The Law and Economics Movement". In *Law and Economics*, edited by Richard A. Posner and Francesco Parisi, 3-16. Cheltenham: Edward Elgar Publishing, 1997.

Posner, Richard A., and Francesco Parisi. "Wealth Maximization Revisited". In *Law and Economics*, edited by Richard A. Posner, 52-75. Cheltenham: Edward Elgar Publishing, 1985.

Prasad, Krishna. "The Boom in Asset Securitisation". In *Asset Securitisation and Synthetic Structures: Innovations in the European Credit Markets*, edited by Rick Watson and Jeremy Carter, 3-10. London: Euromoney, 2006.

PriceWaterhouseCoopers, and Queen Mary, University of London. "International Arbitration: Corporate Attitudes and Practices". 1-28. London, 2008.

Qutb, S. *Social Justice in Islam*. New York: Octagon Books, 1970.

Rahim, Abdur. *The Principles of Islamic Jurisprudence*. New Delhi: Kitab Bhavan, 1994.

Rahman, A.R. Abdul. "Issues in Corporate Accountability and Governance: An Islamic Perspective". *American Journal of Islamic Social Sciences* 15, no. 1 (1998): 55-69.

Rahman, Fazlur. "Riba and Interest". *Islamic Studies* III (1964): 1-44.

Ramadan, Tariq. *Western Muslims and the Future of Islam*. Oxford Oxford University Press, 2004.

Rand, Ayn. *Atlas Shrugged.* London: Penguin Books, 2007.

Ratings, Fitch. "Fitch's Approach to Rating Sukuk". 1-5: Fitch Ratings, 2007.

Ray, Nicholas Dylan. *Arab Islamic Banking and the Renewal of Islamic Law*. London: Graham & Trotman, 1995.

———. "The Medieval Islamic System of Credit and Banking: Legal and Historical Considerations". *Arab Law Quarterly*, no. 12 (1997): 43-90.

Rayner, Susan E. *The Theory of Contracts in Islamic Law*, Arab and Islamic Laws Series. London: Graham & Trotman, 1991.

Redfern, Alan, Martin Hunter, Nigel Blackaby, and Constantine Partasides. *Redfern and Hunter on International Arbitration*. Oxford: Oxford University Press, 2009.

Renner, Karl. *The Institutions of Private Law and Their Social Functions*, edited by O. Kahn-Freund. London: Routledge and Kegan Paul, 1976.

Resource, Islamic Finance. "AAOIFI Shariah Council's Proposals for Amendments in Contemporary Sukuk Issues". (2008). Available at:

http://ifresource.com/2008/05/21/aaoifi-shariah-councils-proposals-for-amendments-in-contemporary-sukuk-issues/.

Reuters. "British Gilt Issuance to Hold Broadly Steady in 08/09". (2008). Available at: http://uk.reuters.com/article/2008/03/07/britain-budget-gilts-idUKL0776505020080307

———. "Factbox: Basel III Banking Agreement". (2010). Available at: http://www.reuters.com/article/2010/09/12/us-basel-banks-fb-idUSTRE68B1ZG20100912

Richardson, Edana. "The Integration of Islamic Finance into the Irish Legal System". 1-71. Dublin: Trinity College, 2011.

Rodinson, Maxime. *Islam and Capitalism*. London: Allen Lane, 1974.

Rose, Norton. "The Implications for the Islamic Finance Market of the Investment Dar Company KSCC v Blom Developments Bank SAL [2009] EWHC 3545 (Ch) " Norton Rose. (2010). Available at: http://www.nortonrose.com/knowledge/publications/27334/the-implications-for-the-islamic-finance-market-of-the-investment-dar-company-kscc-v-blom-developments-bank-sal-ewhc-3545-ch

———. "MPs Confirm UK Commitment to Islamic Finance at Norton Rose Event". 1-2. London: Norton Rose, 2010.

Rose, Peter S., and Milton H. Marquis. *Money and Capital Markets: Financial Institutions and Instruments in a Global Marketplace*, Finance, Insurance and Real Estate. New York: McGraw-Hill Irwin, 2008.

Rosen, Lawrence. "Law and Custom in the Popular Legal Culture of North Africa". *Islamic Law and Society*, no. 2 (1995): 194-209.

Rosly, Saiful Azhar, and Mahmood M. Sanusi. "The Application of Bai' Al-'Inah and Bai' Al-Dayn in Malaysian Islamic Bonds: An Islamic Analysis". *International Journal of Islamic Financial Services* 1, no. 1 (1999): 1-16.

Ruggie, John Gerard. "Continuity and Transformation in the World Polity: Toward a Neorealist Synthesis". *World Politics* 35, no. 2 (1983): 261-85.

———. "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order". *International Organization* 36, no. 2 (1982): 379-415.

Rushd, Ibn. *The Distinguished Jurist's Primer, a Translation of Al-Bidayat Al-Mujtahid*. Translated by Imran Ahsan Khan Nyazee. Vol. II. Reading: Garnet Publishing Limited, 1996.

Sadr, Muhammad Baqr. *Iqtisaduna : Our Economics*. Tehran: WOFIS, 1982.

Saeed, Abdullah. *Islamic Banking and Interest*. Edited by Ruud Peters and Bernard Weiss. Vol. 2, Studies in Islamic Law and Society. Leiden: E.J. Brill, 1996.

———. "Riba: Encyclopedia of Islam, Second Edition". Brill Online, 2008.

Saillon, Antoine. "Islamic Banking Finally Staring in France". *IFN Reports*8 , no. 27 (2011): 1.

Salah, Omar. "Dubai Debt Crisis: A Legal Analysis of the Nakheel Sukuk". *Berkeley Journal of International law Publicist* 4 (2010): 19-32.

Saleh, Nabil. "Are the Validity and Construction of Legal Acts Affected by Cause (Sabab)?" *Arab Law Quarterly* 7, no. 2 (1992): 116-40.

Saleh, Nabil A. *Unlawful Gain and Legitimate Profit in Islamic Law*. Cambridge: Cambridge University Press, 1986.

Santos, Boaventura de Sousa. "Law: A Map of Misreading. Toward a Postmodern Conception of Law". *Journal of Law and Society* 14, no. 3 (1987): 279-302.

———. "On Modes of Production of Law and Social Power". In *Regulation*, edited by C. Scott, 299-336. Aldershot: Ashgate Publishing, 1985.

———. *Toward a New Common Sense*. New York: Routledge, 1995.

———. *Toward a New Legal Common Sense: Law, Globalisation, and Emancipation*. London: LexisNexis Butterworths, 2002.

Santos, Joao Cabral dos. "Bank Capital Regulation in Contemporary Banking Theory: A Review of the Literature". *Financial Markets, Institutions & Instruments* 10, no. 2 (2001).

———. "Commercial Banks in the Securities Business: A Review". *Working Paper, Federal Reserve Bank of Cleveland* 96, no. 10 (1998).

Sassen, Saskia. *Globalization and Its Discontents*. New York: New Press, 1998.

Saudi Arabia, Kingdom Of (Ministry of Foreign Affairs). "The Basic Law of Governance". (1992). Available at: http://www.saudiembassy.net/about/country-information/laws/The_Basic_Law_Of_Governance.aspx

Saw, Swee-Hock, Karyn Wang, and Saw Centre for Financial Studies. *Introduction to Islamic Finance*. Singapore: Saw Centre for Financial Studies, 2008.

———. *Theory and Practice of Islamic Finance*. Singapore: Saw Centre for Fianancial Studies, 2008.

Schacht, Joseph. *Das Kitab Al-Hijal Fil-Fiqh (Buch Der Rechtskniffe) Des Abu Hatim Mahmud Ibn Al-Hasan Al-Qazuini*. Translated by Joseph Schacht. Hannover: Orient-Buchhandlung Heinz Lafaire, 1924.

———. "Die Arabische Hijal-Literatur: Ein Beitrag Zur Erforschung Der Islamischen Rechtspraxis". *Der Islam* XV (1926): 211-32.

———. "Fiḳh." *Encyclopaedia of Islam, Second Edition*. Edited by: P. Bearman; Th. Bianquis; C.E. Bosworth; , E. van Donzel; and W.P. Heinrichs. Brill, 2011. Available at: <http://www.brillonline.nl/subscriber/entry?entry=islam_SIM-2365>

———. "Foreign Elements in Ancient Islamic Law". *Journal of Comparative Legislation and International Law* 32 (1950): 9-17.

———. "From Babylonian to Islamic Law". *Yearbook of Islamic and Middle Eastern Law* 1 (1994): 29-33.

———. *An Introduction to Islamic Law*. Oxford: Clarendon Press, 1964.

———. *The Origins of Muhammadan Jurisprudence*. Oxford: Clarendon Press, 1950.

———. "Pre-Islamic Background and Early Development of Jurisprudence". In *Law in the Middle East*, edited by Majid Khadduri and Herbert J. Liebesny, 28-57. Washington, D.C.: The Middle East Institute, 1955.

———."Ribā." *Encyclopaedia of Islam, Second Edition*. Edited by: P. Bearman; Th. Bianquis; C.E. Bosworth; E. van Donzel; and W.P. Heinrichs. Brill, 2011. Available at: <http://www.brillonline.nl/subscriber/entry?entry=islam_COM-0918>

———. "Zur Soziologischen Betrachtung Des Islamischen Rechts". *Der Islam* XXII-XXIII (1935): 207-39.

Schneider, Howard, and Edward Cody. "Standard & Poor's Cuts Credit Ratings for France and Eight Other European Nations". (2012). Available at: http://www.washingtonpost.com/business/economy/france-loses-aaa-in-euro-downgrade/2012/01/13/gIQAxALzwP_story.html.

Schoenmaker, D. "Contagion Risk in Banking". In *LSE Financial Markets Group Discussion Paper*. London: London School of Economics, 1996. Available at: http://www.imes.boj.or.jp/cbrc/cbrc-03.pdf

Schoon, Natalie. *Islamic Banking and Finance*. London: Spiramus Press, 2009.

Searle, John R. *The Construction of Social Reality*. London: Penguin Books, 1996.

Secretariat, The UK Islamic Finance. "Background" (2011). Available at: "Http://Www.Secinst.Co.Uk/Bookmark/Genericform.Aspx?Form=29848780&Url=Ukifsaboutus".

Shachar, Ayelet. *Multicultural Jurisdictions: Cultural Differences and Women's Rights*. Cambridge: Cambridge University Press, 2001.

Shakil, Mansoor. "The Impact of Basel II on the Future of Islamic Banking". In *Islamic Finance: Current Legal and Regulatory Issues*, edited by Nizam Ali, 153-65. Cambridge: Islamic Finance Project, Harvard Law School, 2005.

Shaukat, Mughees. "Sale of Goods and Sale of Debt: A Comparative Analysis". In *INCEIF Paper*, 1-36: INCEIF, 2010.

Sheppard, Audley. "Arbitration of International Financial Disputes". In *Kluwer Arbitration Blog*. London: Wolters Kluwer, 2009. Available at: http://kluwerarbitrationblog.com/blog/2009/03/19/arbitration-of-international-financial-disputes/

Shikder, Muhammad Nurullah. "Placing Faith in Islamic Finance". *New Horizon*, no. January-March (2009): 30-32.

Siddiqi, Muhammad Nejatullah. *Banking without Interest*. Lahore: Islamic Publications Limited, 1973.

———. *Muslim Economic Thinking: A Survey of Contemporary Literature*. Leicester: The Islamic Foundation, 1981.

Simmel, Georg. *The Philosophy of Money*. Translated by David Frisby and Tom Bottomore. Edited by David Frisby. London: Routledge, 1990.

Singh, Habhajan. "Absence of Shariah Audit a 'Serious Loophole'". In *Malaysian Reserve.* (2009). Available at: http://2.bp.blogspot.com/_PGH0ddCyO7U/Skrsjw4GpsI/AAAAAAAAAZw/q-ro7fBbfi4/s1600-h/090629-TMR-ShariahAudit-MASB-IssamRasameel-p32.JPG

Sloane, Peter D. "The Status of Islamic Law in the Modern Commercial World". *The International Lawyer* 22 (1988): 743-66.

Smith, Adam. *The Wealth of Nations*. Oxford: Oxford University Press, 1993.

Smith, Kristin. "Islamic Banking and the Politics of International Financial Harmonization". Paper Presented at Harvard University Forum on Islamic Finance. *Islamic Finance: Current Legal and Regulatory Issues*, edited by Nazim Ali, 167-89. Cambridge: Harvard Law School, 2005.

Sole, Juan. "Introducing Islamic Banks into Conventional Banking". In *Islamic Banking and Finance*, edited by Amer Al-Roubaie and Shafiq Alvi, 106-30. London: Routledge, 2010.

Sorenson, Bjorn. "Ethical Money: Financial Growth in the Muslim World". *American University International Law Review* 23 (2008): 647-59.

Stein, Peter. *Legal Institutions: The Development of Dispute Settlement*. London: Butterworths, 1984.

Storper, Michael. "Lived Effects of the Contemporary Economy: Globalization, Inequality, and Consumer Society". In *Millenial Capitalism and the Culture of Neoliberalism*, edited by Jean Comaroff and John L. Comaroff, 88-125. Durham: Duke University Press, 2001.

Strange, Susan. *Mad Money*. Manchester: Manchester University Press, 1998.

Sugarman, David. "Law, Economy and the State in England, 1750-1914: Some Major Issues". In *Legality, Ideology and the State*, edited by David Sugarman, 213-66. London: Academic Press, 1983.

Sundararajan, V. "Risk Characteristics of Islamic Products: Implications for Risk Measurement and Supervision". In *Islamic Finance: The Regulatory Challenge*, edited by S. Archer and R. Karim, 40-68. Singapore: John Wiley & Sons (Asia), 2007.

Sundararajan, V., and Luca Errico. "Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead". 1-28. Washington, D.C.: International Monetary Fund, 2002.

Sunstein, C. *After the Rights Revolution: Reconceiving the Regulatory State*. Cambridge: Harvard University Press, 1990.

Tabb, William K. "Financialization in the Contemporary Social Structure of Accumulation". In *Contemporary Capitalism and Its Crises: Social Structure of Accumulation Theory for the 21st Century*, edited by Terrence McDonough, Michael Reich and David M. Kotz, 145-68. Cambridge: Cambridge University Press, 2010.

Tameme, Mohammed Elkhatim Mamoun. "Demand and Supply Conditions of Islamic Housing Finance in the UK: Perceptions of Muslim Clients". University of Durham, Ph.D. Thesis, 2009.

Taylor, Charles. "Multiculturalism and the Politics of Recognition". In *Multiculturalism and the Politics of Recognition*, edited by Amy Gutmann, 25-75. New Jersey: Princeton University Press, 1992.

Tett, Gillian. *Fool's Gold : How Unrestrained Greed Corrupted a Dream, Shattered Global Markets and Unleashed a Catastrophe*. London: Abacus, 2010.

Teubner, Gunther. *Law as an Autopoietic System*, European University Institute Press Series. Oxford: Blackwell Publishers, 1993.

Thomas, Abdulkadar. "Malaysia's Importance to the Sukuk Market: March 2007 Report". *Ajif American: Journal of Islamic Finance*

http://iimm.bnm.gov.my/view.php?id=75&dbIndex=0&website_id=14&ex=1312809359&md=%ED%0B%A39%B4m%BF%E5r%B0%DA9rGf%BD (2007): 1-8.

Thomas, Abdulkader S., Stella Cox, and Bryan Kraty. *Structuring Islamic Finance Transactions*. London: Euromoney Books, 2005.

Torrey, Charles C. "The Commercial-Theological Terms in the Koran". University of Strassburg, Ph.D. Thesis, 1892.

Treasury, Her Majesty's. "The Development of Islamic Finance in the UK: The Government's Perspective". 1-30. London: HM Treasury, 2008.

———. "Government Sterling Sukuk Issuance: A Consultation". 1-28. London: HM Treasury, 2007.

———. "Alternative Finance Products, Regulatory Impact Assessment". 1-9. London: HM Treasury, 2007.

———. "Government Sterling Sukuk Issuance: A Response to the Consultation". 1-52. London: HM Treasury, 2008.

Tripp, Charles. *Islam and the Moral Economy*. Cambridge, UK: Cambridge University Press, 2006.

Twining, William. *Globalisation and Legal Theory*. London: Butterworths, 2000.

Uberoi, Priya, Rahul Chatterji, and Dany Bidar. "Promises on the Horizon: An Introduction to the Wa'ad". 1-9: Allen & Overy, n.d. Available at: http://www.allenovery.com/AOWeb/binaries/52774.PDF

Udovitch, Abraham L. "At the Origins of the Western Commenda: Islam, Israel, Byzantium?" *Speculum* 37, no. 2 (1962): 198-207.

———. "The Constitution of the Traditional Islamic Marketplace: Islamic Law and the Social Context of Exchange". In *Patterns of Modernity: Beyond the West*, edited by S.N. Eisenstadt, 150-72. London: Frances Pinter Publishers, 1987.

———. "The "Law Merchant" of the Medieval Islamic World". In *Logic in Classical Islamic Culture*, edited by G.E. von Grunebaum, 113-31. Wiesbaden: Otto Harrassowitz, 1970.

———. *Partnership and Profit in Medieval Islam*. Princeton: Princeton University Press, 1970.

Unal, Murat. "Shariah Scholars in the GCC-A Network Analytic Perspective". 1-25: Funds@Work, 2009. Available at: www.assaif.org/.../Shariah%20Scholars%20-%20Network%20Analysis%20...

Usmani, Muhammad Taqi. *An Introduction to Islamic Finance*. The Hague: Kluwer Law International, 2002.

———. "Sukuk and Their Contemporary Applications". 1-14: http://www.sukuk.me/library/education/MuftiTaqiSukukpaper.pdf, 2008.

Uzair, M. "Impact of Interest Free Banking". *Journal of Islamic Banking and Finance* 1, no. 4 (1984): 39-51.

van Duyn, Aline. "The US Holds Its Breath on Bonds". *Financial Times*, 2009.

Veljanovski, C. "Introduction". In *Regulation or over-Regulation?*, edited by A. Seldon. London: Institute of Economic Affairs, 1988.

Vesey-Fitzgerald, Seymour. "The Alleged Debt of Islamic to Roman Law" In *Law Quarterly Review* 67 (1951): 81-102.

Vikor, Knut S. "The Shari'a and the Nation State: Who Can Codify the Divine Law?" In *The Middle East in a Globalized World*, edited by Björn Olav Utvik and Knut S. Vikor, 220-50. London: C. Hurst & Co., 2000.

Visser, Hans. *Islamic Finance*. Cheltenham: Edward Elgar Publishing, 2007.

Vogel, Frank E., and Samuel L. Hayes. *Islamic Law and Finance: Religion, Risk, and Return*. Edited by Mark S.W. Hoyle, Arab and Islamic Laws Series. the Hague: Kluwer Law International, 1998.

Wakin, Jeanette A. *The Functions of Documents in Islamic Law*. Albany: University of New York Press, 1972.

Walker, G.A. *International Banking Regulation: Law, Policy and Practice*. The Hague: Kluwer Law International, 2001.

Warde, Ibrahim. *Islamic Finance in the Global Economy*. Edinburgh: Edinburgh University Press, 2000.

Watson, Alan. *Legal Transplants: An Approach to Comparative Law*. 2nd ed. Athens: University of Georgia Press, 1993.

———. *The Nature of Law*. Edinburgh: Edinburgh University Press, 1977.

Watt, W. Montgomery. *Muhammad at Mecca*. Oxford: Oxford University Press, 1953.

Wedderburn-Day, A. Roger. "Sovereign Sukuk: Adaptation and Innovation". *Law and Contemporary Problems* 73, no. Fall (2010): 325-33.

Weiss, Bernard. "Interpretation in Islamic Law: The Theory of Ijtihad". *American Journal of Comparative Law* 26 (1978): 199-210.

———. *The Spirit of Islamic Law*. Atlanta: University of Georgia Press, 1998.

Wigglesworth, Robin. "Sharia Compliance Rulings Reverse Trend". *Financial Times*, 2009.

———. "Tawarruq Loans Split Scholars". *Financial Times*, 2009.

Williams, Rowan. “Civil and Religious Law in England: A Religious Perspective”. *Ecclesiastical Law Journal* 10 (2008): 262-282.

———. "Archbishop's Lecture - Civil and Religious Law in England: A Religious Perspective”. (2008). Available at: http://www.archbishopofcanterbury.org/articles.php/1137/archbishops-lecture-civil-and-religious-law-in-england-a-religious-perspective

Wilson, Rodney. "Challenges and Opportunities for Islamic Banking and Finance in the West: The United Kingdom Experience”. In *Islamic Banking and Finance*, edited by Amer Al-Roubaie and Shafiq Alvi, 358-77. New York: Routledge, 2010.

———. "Islamic Banking in the United Kingdom”. In *Islamic Banking and Finance in the European Union*, edited by M. Fahim Khan and Mario Porzio, 212-21. Cheltenham: Edward Elgar, 2010.

———. "Islamic Investment Products Available in the United Kingdom”. Institute for Islamic Banking & Insurance. (n.d.). Available at: http://www.islamic-banking.com/iarticle_4.aspx

———. "Overview of the Sukuk Market”. In *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk*, 3-17. London: Euromoney Books, 2004.

———. "Regulatory Challenges Posed by Islamic Capital Market Products and Services”. In *Islamic Banking and Finance*, edited by Amer Al-Roubaie and Shafiq Alvi, 377-92. London: Routledge, 2010.

Wood, Philip R. *Comparative Law of Security and Guarantees*. London: Sweet & Maxwell, 1995.

———. *Conflict of Laws and International Finance*. London: Sweet & Maxwell, 2007.

———. *Principles of International Insolvency*, The Law and Practice of International Finance. London: Sweet & Maxwell, 2007.

———. *Project Finance, Securitisations, Subordinated Debt*, Law and Practice of International Finance. London: Sweet & Maxwell, 2007.

———. *Title Finance, Derivatives, Securitisations, Set-Off and Netting*, Law and Practice of International Finance. London: Sweet & Maxwell, 1995.

———. *Project Finance, Subordinated Debt and State Loans*. London: Sweet & Maxwell, 1995.

Wood, Simon A. *Christian Criticisms, Islamic Proofs: Rashid Rida's Modernist Defense of Islam*. Oxford: Oneworld Publications, 2006.

Woodman, Gordon R. "The Idea of Legal Pluralism”. In *Legal Pluralism in the Arab World*, edited by Baudouin Dupret, Maurits Berger and Laila al-Zwaini, 3-21. The Hague: Kluwer Law International, 1999.

Y-Sing, Liau. "Islamic Finance Set for Big China Leap". *Reuters*, 2 October 2009.

Young, Ernst &. "The Islamic Funds & Investments Report". 1-68: Ernst & Young, 2008. Available at: http://www.ncusar.org/programs/09-02-17-materials/EY_Islamic_funds_investment_report_2008.pdf

Zaring, David. "International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations". *Texas International Journal of Law* 33 (1998): 282-327.

Zhu, Haibin. "Capital Regulation and Banks' Financial Decisions". In *BIS Working Papers*. Basel: Bank for International Settlements, 2007.

Zubaida, Sami. *Law and Power in the Islamic World*. London: I.B. Tauris, 2003.

Zweigert, Konrad, and Hein Koetz. *Introduction to Comparative Law*. Oxford: Clarendon Press, 1998.

Zysow, Aron. "The Problem of Offer and Acceptance: A Study of Implied-in-Fact Contracts in Islamic Law and Common Law". *Cleveland State Law Review* 34 (1985-1986): 69-78.