DEVELOPING FINANCIAL LAW IN CONFORMITY WITH ISLAMIC PRINCIPLES: STRICT INTERPRETATION, FORMALISM OR INNOVATION?

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I INTRODUCTION

Currently it is estimated that about 20 per cent of the world's population follows the Islamic religion[1] and that this number is rising so that soon one in four people in the world will be an adherent.[2] Many of these people live in the Middle East, although there are also large Muslim populations in Africa, India, Bangladesh, Pakistan, and Indonesia, and growing numbers in China.[3] The degree to which these Muslim communities enforce the requirements of their religion by way of law varies across a broad spectrum: from Turkey—which is 99 per cent Islamic, but applies secular law—to Saudi Arabia and Iran, where Islamic Shari'a[4] doctrine informs the legislative framework.

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[1] Teresa Allen, 'Islamic Law: Conflicts and Contrasts with Non-Islamic Systems', <http://arastarworld.com-/fiesta/Islam.htm>, 1999 [1]. For statistics on Islamic growth rates, see also David Calhoun (ed), *Encyclopedia Brittanica Book of the Year* (1997) 310.

[2] See Raymond August, *International Business Law* (1993) 51. See also Calhoun, above n 1.

[3] Allen, above n 1, [1].

[4] Shari'a refers to the canonical laws of Islam. It specifically includes the laws of the *Qur'an* directly revealed to Mohammed, and the *Sunnah*, or collected sayings and actions of the Prophet. These have been further elaborated by the teachings of the four orthodox schools of interpretation (Shafi'i, Hanbali Maliki and Hanafi), together with that of the Shi'ites and Ja'fari. See Cyril Glassé, *The Concise Encyclopaedia of Islam* (1989) 361. See also, the 'Shari'ah and Fiqh' website, <http://www.usc.edu/dept-/MSA/law/shariaintroduction.html> [3].

Early in 1999 the Pakistani government, which is strongly Islamic, sought guidance from its Shari'a Court as to how to comply with religious strictures impinging upon commercial practices.[5] Some eight years previously the same court had rejected 32 financial laws, including ones approving 'mark-up' as an alternative to interest, as inconsistent with the Islamic faith, but this ruling had long been ignored as impracticable, especially by the banking community. The Minister for Justice now wishes the Shari'a court to provide 'the outlines of a viable system and clarify exactly how the law should be framed'[6] in order to ensure compliance with Islamic religious tenets.

This request has caused considerable anxiety amongst the Islamic financial community, as it raises the question whether compliance with the *spirit* of Islamic law, as opposed to its *form*, is a commercial possibility. The Pakistani Shari'a Court's decision that mark-ups were too close to *riba* or interest (which is forbidden by the Islamic religion) seems to indicate an intention to discard devices which substitute the observance of merely formal requirements for the substantive obligations imposed by Islam on its followers. Whilst this is ethically admirable, it is not clear how it can be achieved in today's complex society, nor whether such a system will preclude interaction with Western commerce. However, given the resurgence of religious fundamentalism throughout the world, and the rapid spread of Islam, the question of the viability of a 'genuinely Islamic' commercial law—one that is Islamic in moral content and not just in form—is both relevant and economically important.

In order to determine this question, it will first be necessary to define the ethical principles relevant to the Islamic commercial system, the inherent problems in applying these principles to modern commercial situations and, specifically, the areas where there is currently a conflict between formalism and the underlying substantive content of Islamic law. The paper will then look at possible approaches to the question of whether there is an Islamic commercial law.

II PROBLEMS IN ASCERTAINING THE MORAL CONTENT OF ISLAMIC LAW

The question of how to implement a substantively authentic Islamic commercial or financial law system is one that is of interest and concern for all sincere Muslims, whether they are residents of countries like Pakistan, with legislative systems based on sacred Shari'a law, or of secular states such as Australia, Turkey or the USA. The problem is to ascertain the prescriptive moral underpinnings of Islamic teaching and ensure that these are not contravened in commercial transactions. Unfortunately, there are several barriers to discerning cohesive moral principles in this area.

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[5] See 'Money, Religion Struggle to Mix', *The Australian* (Sydney) 4 February 1999, 30.
[6] Ibid.

A *Supra-rational and Rational Sources of Islamic Law*

There are four main sources of Islamic law, of which two are the *Qu'ran*—held to be the word of Allah—and the *Sunna*—a collection of *hadith* or inspired guides to conduct deriving from the prophet Mohammed. These are both taken to be expressions of divine will and so not susceptible to rational questioning, but must be accepted as tenets of faith. The second two sources are *qiyas* or arguments from analogy, and *i'jma*, or decisions arrived at by consensus of the Islamic community.[7] *Qiyas* derive from human reasoning which has been applied to given moral principles, and therefore cannot claim the same level of infallibility enjoyed by the *Qu'ran* and the *Sunna*. *I'jma* occupy an intermediate position—these decisions are the product of human reason, but reasoning for which the Prophet claimed some kind of divine guidance when he announced 'My community will never agree on error'. Accordingly, if one is trying to separate moral imperatives from what is merely desirable conduct, some differentiation must be made between those principles deriving solely from a supra-rational source and those with rational components which are, to that extent, fallible and ethically non-binding. Indeed, Shi'ite Muslims accept only the *Qu'ran* and *Sunna* as sources of moral law, and even discard any *hadith* from the latter source if it is not affirmed by a Shi'ite imam.[8]

Rene David and John Brierly, in their book *Major Legal Systems in the World Today*[9] assert that the Shari'a is highly formalistic, requiring observance of the letter of the law, rather than its spirit. This is a sentiment with which Joseph Schacht concurs, attributing this formalism to the 'heteronymous and irrational side of Islamic law'.[10] All three scholars consider the supra-rational aspect to be provided only by the *Qu'ran* and *Sunna*, and appear to believe that the appropriate reaction to such teachings is observance of form alone. This is curious, since adherents of many religions follow the spirit, rather than the formalistic requirements, of the supra-rational tenets of their faith—for example the avoidance by Christians and Jews of sexually explicit thoughts in adherence to the divine commandment not to commit adultery. There seems to be no overwhelming reason why, when supra-rational tenets of faith inform legal duties, Muslims should not respond by seeking to comply with the actuating spirit, rather than observance of dry form. Indeed, one would think that this is the appropriate response to ethical teachings considered to derive from a supra-rational source.

If a belief system has a transcendent value deriving from the supra-rational decrees of an Almighty Deity, then presumably it must be upheld whatever the material cost. Mere formalistic compliance with them will more likely result in a circumvention of the moral imperatives. On the other hand, if material gain and the ability to interact with western financiers is pre-eminently important, then it is adherence to

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[7] See Joseph Schacht, *An Introduction to Islamic Law* (1982) 13.
[8] Allen, above n 1, 5.
[9] (3rd ed, 1985) 468.
[10] Schacht, above n 7, 14.

form but not the spirit which is important, but this may thereby be of lesser ethical value.

B *Five Heterogenous Categories of Action*

In addition to the problem of non-rational and rational sources of Islamic law, there are five categories of daily actions for Muslims, ranging from the Mandatory (sub-divided into those actions which are personally obligatory on all adherents of the faith,[11] and those which are communally obligatory[12]) to the Forbidden, or *Haram*.[13] In this latter category falls the taking of *riba*, the eating of pork, indulgence in gambling and drinking of alcohol. Between these extremes lie the categories of Recommended, Permissible and Disapproved, for none of which is any punishment incurred, although performance or abstinence from actions falling within these classifications may be rewarded as appropriate.[14] By contrast, omission of the Prescribed, and commission of the Forbidden, merit moral punishment. This continuum somewhat blurs the distinction between the non-rational and the rational origins of different acts by applying ethical, but not legal, sanctions or rewards to all actions irrespective of whether the breach is of a divine or of a merely human imperative.

C *Interpretation Based on Different Conceptualisation*

Any attempt to arrive at the essential moral principles of the Islamic faith is further complicated by the existence of multiple schools of interpretation. The major division is along the lines of the valid succession to the Prophet, which produced the Sunni and Shi'ite sects. Within these divisions arise further schools of interpretation according to the views of different *Imams* or jurists. Thus the Sunni school includes the followers of Imam Abu Hanafi, with a relatively liberal interpretation of the requirements of Islamic law; the adherents of the conservative Maliki interpretation of the same body of knowledge; the Shafi'i school, which does not accord to '*urf* or custom the same importance as is granted by other schools; and the more fundamentalist Hanbali school of interpretation which stresses the primacy of the *Qu'ran*

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[11] Such as the payment of *zakat*/religious dues—see the *Qu'ran*, Sura Al Baqarah, 2:110, 277 (references to the *Qu'ran* hereafter will be to the book and name only—Sura indicates a Book of the *Qu'ran*, followed by the name of the book (al- Baqarah means, for example, the cow). The numbers show the position of the book in the *Qu'ran*, followed by the verse number –so as al-Baqarah is the 2nd book, a quote from there will always be 2: + verse number. Tradition seems to require both name and book number to be given. There is a problem citing from any translation, as Muslims believe that only the Arabic version is the *Qu'ran*, translations are not—but as I do not speak Arabic, I usually quoted from 'a plain English translation ... by Muhammad Sarwar' to be found at <http://web).tiac.net/users-/islam/sq/2.htm>. This was frequently checked against translations of Yusuf Ali, Marmaduke Mohammad Pickthall and M H Shakir, all to be found at <http://www.usc.edu/dept/MSA-/quran/qmtintro.html.>). See also Glassé, above n 4, 132, 134. Also Shari'ah and Fiqh, above n 4.

[12] These—for example the saying of funeral prayers—may be fulfilled by observance by only some members of a community. See Glassé, above n 4, 132, 134; Shari'ah and Fiqh, above n 4.

[13] See, for example, Sura Al Baqarah (2:219 & 275). See also Susan Rayner, *The Theory of Contracts in Islamic Law* (1991) 131.

[14] See Shari'ah and Fiqh, above n 4.

and *Sunna* in discovering the Way of Allah.[15] This latter feature is also insisted upon by Shi'ites, or upholders of the succession of Ali (son-in-law to the Prophet).[16]

The existence of these schools has led to a plethora of interpretations of the meanings of various terms, some of which have important implications in the determination of the essential elements of Islamic law. For example, the taking of unjustified profit (*riba*) falls within the forbidden category of actions, but the situations in which profits may be classified as unjustified will vary with the schools of interpretation, depending on the level of conceptualisation employed. Thus one *hadith* exhorts the faithful to 'Sell gold for gold, silver for silver, wheat for wheat, barley for barley, date for date, salt for salt in the same quantities on the spot.'[17] According to a literalist Hanafi interpretation, such an injunction is restricted in its financing application to those currencies characterised by weight and extrinsic value—for example, gold and silver coinage—but would not apply to foreign exchange transactions involving paper currencies, which, while being a store of value, have no extrinsic worth. At the other end of the scale, Shafi'is and Malikis would consider the problem from a higher level of abstraction, holding the requirement for exchange of the same quantities of money in an on-the-spot transaction precludes profit since currencies of whatever physical nature share the same defining characteristic of being a store of value. Consequently for them, the *hadith* apparently applies to any currency.[18]

D *Differing Connotations for Important Words*

There is also sometimes disagreement concerning the meaning of an important word. The *Qu'ran* is written in Arabic, but even in the original, it appears that the meaning of '*riba*' is not unambiguous, and could refer to any interest or gain at all, or only to excessive or unlawful profit. The *Qu'ran* does not assist greatly in clarification. It states that '[t]hose who take *riba* will stand before Allah (on the Day of Judgment)',[19] and '[i]f you will not give up the *riba* which you demand, know that you are in the state of war with Allah and his Messenger.'[20] The Islamic Fiqh Academy[21] in 1986 held that all interest-bearing transactions were to be condemned and are void.[22] This decision was of enormous potential significance to anyone involved with Islamic banking and financial transactions. However, the actual significance of

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[15] See Allen, above n 1, 7.

[16] See John Strawson, 'Encountering Islamic Law', (1999) <http://www.uel.ac.uk/faculties-/socsci/law/jsrps.html> (copy on file with author) [14].

[17] See Mohammed Obaidullah, 'Islamic Forex Trading' (1999) <http://www.ximb.stpbh.-soft.net/faculty/obeid/INTER4-.HTM> (copy on file with author) [7]. This is an example of *riba al-buyu*—see below, at n 32-4 and accompanying text.

[18] Obaidullah, above n 17, [10-17].

[19] Sura Al-Baqarah, 2:275. Note that in this and future citations from the Qu'ran referring to '*riba*', the word itself has been left untranslated to avoid pre-judging its precise denotation, which is almost impossible to translate into English accurately.

[20] Sura Al-Baqarah, 2:279.

[21] An institution dedicated to the study and elaboration of Islamic jurisprudence.

[22] Allen, above n 1, [69].

the finding has been substantially mitigated by legislation in a number of Islamic countries allowing the imposition of service charges equivalent to interest rates,[23] or permitting simple interest,[24] or interest at rates specified by government ministries.[25] This is sometimes justified on the basis of necessity if Muslim financiers are to participate in the modern commercial arena, and sometimes on the strength of a verse of the *Qu'ran* which enjoins the faithful 'not [to] live on *riba*, doubling your wealth many times over'.[26] This statement, it is argued, indicates that what is forbidden is excessive interest, rather than interest per se.

III APPLYING ETHICAL PRINCIPLES TO NEW CIRCUMSTANCES

Even if it is possible to identify the moral principles underpinning Islamic law, the problem of applying these to modern commercial practices remains. Whilst Islamic law developed for 400 years after its inception around 600 AD, the rise of the doctrine of consensus, following the emergence of Imam Ahmad ibn Hanbal's school of interpretation in the10th century, marked something of a turning point in Islamic jurisprudence. This required broad agreement within the Islamic community before any new interpretation or application of existing teachings could be accepted. Many Western writers have referred to the subsequent phenomenon as the '*bab al-ijtihad*', or the closing of the door of independent reasoning, when the threat of schism resulted in diminished tolerance of further human interpretation of divine decrees.[27] Whilst the completeness of the proscription of theological reasoning is now open to doubt,[28] and it appears that some independent thought has always been applied to understanding the *Qu'ran* and *Sunna*, nevertheless it remains true that most authoritative doctrine was elaborated before the end of the 10th century. Since those accepted teachings relating to commercial law tend to deal with narrowly specific, pre-10th century situations (for example, the exchange of fruit of quality A for quality B), their application to modern commercial practices consequently involves the use of '*qiyas*' or rational arguments from analogy.

Moreover, as mentioned earlier, there can be no definitive answer to the question whether a *hadith* originally dealing with profit-making from on-the-spot trading of gold for gold or silver for silver applies to today's paper currencies which store value in the same way as gold and silver currencies 10 centuries ago, or is restricted to currencies with extrinsic value, since arguments from analogy can be constructed based on different levels of conceptualisation. And the matter becomes even more problematical when foreign exchange involving electronic currency transfers are

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[23] See, for example, Saudi Arabia's *Banking Control Law of 1966*.
[24] See, for example, the *Commercial Code (Law 18/1993)* of the United Arab Emirates.
[25] See, for example, Oman's *Commercial Law No 55/1990*.
[26] Sura Al-Imran, 3:130.
[27] See David and Brierly, above n 9, 471. Also N J Coulson, *A History of Islamic Law* (1978) 5 and Schacht, above n 7, 19.
[28] See Shaista P Ali-Karamali and Fiona Dunne, 'The Ijtihad Controversy' (1994) 9 *Arab Law Quarterly* 238.

considered, since there the individual coins or notes may never be specifically appropriated, making useful analogies even harder to draw.

Further, there is a prohibition known as '*gharar*', or unacceptable risk connected with uncertainty surrounding ability to deliver on the due date.[29] It is recorded in a *hadith* that 'Mahommed forbade a transaction called *habal al-habala*, whereby a man bought a she-camel which was to be the offspring of a she-camel that was still in its mother's womb,[30] and in another place also enjoined 'Do not sell what is not with you'. Analogical reasoning applied to this *hadith* has resulted in orthodox Muslims being forbidden to enter futures contracts in currencies, despite the fact (as Dr Mohammed Obaidullah has pointed out[31]) that modern markets, with free convertibility of currency and no supply-side constraints, ensure ready availability of currency and consequently ability to deliver on maturity date. The risk of inability to deliver due to non-availability of the subject-matter is rendered nugatory and in no way comparable to the risk of not delivering an offspring of specified sex of a yet-unborn camel. Yet this traditional injunction, based on a vastly different order of risk, prevails in this area of modern commercial transactions.

IV *RIBA*—CONFLICT BETWEEN FORMALISM AND CONTENT

One of the most commercially important areas in which a number of writers concede that there is a conflict between the spirit and form of Islamic law relates to *riba*. Although there are different forms of *riba*,[32] the avoidance of *riba al-qarud* is the aim of much Islamic banking practice and the source of a range of *hiyal* or devices that appear somewhat specious in their attempts to adhere to the letter of the law and not its spirit. It is on these devices that attention will here be focussed.

Riba is essentially an unjustified gain resulting from an unfair exchange of counter-values/ consideration between parties to a contract. The *Qu'ran* states, 'Allah has made trade lawful and has forbidden *riba*',[33] and with respect to the fate of those

[29] It is interesting to compare the Islamic prohibition of such transactions with that adopted by many Western common law countries in Sales of Goods Acts modelled on the English legislative template. There, where future goods are sold by description, the property therein passes to the buyer as soon as goods of that description, in a deliverable state, are unconditionally appropriated to the contract with the express or implied consent of the parties—see, for example s 18, r 5 of the *Sale of Goods Act, 1895* (WA).

[30] Obaidullah, above n 17, [32].

[31] Obaidullah, above n 17, [32].

[32] Western commentators sometimes equate *riba* solely with interest, but that is to concentrate on either *riba al-qarud* (see Islamic Finance 'What is Usury?' at Arabic and Islamic Studies, <http://www.islamic-finance.com/item5.htm> [3,4,7] (herafter 'What is Usury?') or *riba al-nasia* (gain from waiting) (see Obaidullah, above n 17, [3]) and neglect *riba al-buyu* (gain from trading), especially in its form of *riba al-fadl* (see 'What is Usury?')

[33] Sura Al-Baqarah, 2:276.

claiming *riba*, that 'If you repent, you may retain your principal, suffering no loss and causing none'.[34]

At this point, one vast difference between Islamic financing law and that of the west becomes apparent, for time is not seen as a countervalue under traditional Shari'a law.[35] Whilst it is axiomatic to westerners that the use of another person's cash for a period of time will entail a cost beyond capital repayment, in Islamic thinking, since time itself can neither be owned, nor be traded in the marketplace, and has no physical characteristics such as weight and length, it does not form part of the consideration of loan contracts. Accordingly, an attempt to impose a charge for use of money over time is condemned as an unfair enrichment for the lender.[36]

Against this view it could be argued that prohibition of *riba* will unfairly enrich the borrower in times of high inflation. A person borrowing $1000 for one year at a time when inflation equals 10 per cent will effectively repay only $909 on the due date, since the purchasing power of the $1000 returned will have diminished against that of the money originally borrowed. It could also be contended that what is being offered as consideration by the lender is not an immaterial substance—time—but a right to use money over time. If the right to use a horse or a machine can be the subject of a contract of hire for which payment is made, it is not immediately apparent why the hiring of money should not also be subject to a hiring charge. True, the hirer of an object will normally require the return of that specific object, whereas the lender/hirer of money does not require the return of the exact same notes, but this does not detract from the essential similarity of the transactions.[37] However, these are rational considerations which cannot be allowed to prevail if the prohibition is accepted as being of divine origin and relates to all interest as opposed to unreasonable or exploitative gain.

A *Formalistic Avoidance of* Riba

In an attempt to finesse the problem, a distinction is apparently drawn between payment of increase on money loans as opposed to the advance of credit for the purchase of goods. With the *bai al-mutlaq* transaction there can be an immediate transfer of ownership in goods, with deferred payment of the purchase price, so long as the goods are in existence and capable of delivery at the time of contracting and the subject matter of the contract is not *haram*[38] under Islamic law. The price to

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[34] Sura Al-Baqarah, 2:279.

[35] See Abdullah Saeed, 'Islamic Banking in Practice: a Critical Look at the Murabaha Financing Mechanism' (1993) 1 *Journal of Arabic, Islamic and Middle Eastern Studies* 63.

[36] Saeed, ibid, cites the Hanafi jurist Jassas who considered that expediting payment of a loan on condition that the creditor reduce the amount would be *riba*. In the same place he also cites Razi, who, in his commentary on *riba*, rejected the view that time allowed for payment could be a countervalue for an increase, because 'it is not goods or a thing which could be pointed at, to make it a countervalue' for the increase.

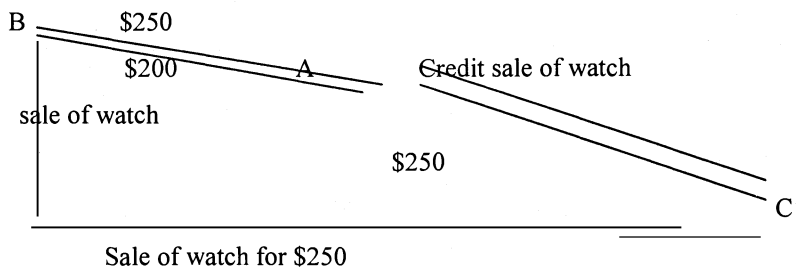
[37] Whilst the specificity of the object might well be important in the categorisation of a *bai*/sale transaction, this is arguably not the case with respect to *ijara*/leasing contracts.

[38] For example, pork, gaming devices, musical instruments etc. See Rayner, above n 13, 131.

be paid eventually must be agreed between the parties at the time of contracting, but may be greater than the cash price for immediate payment, so long as the option of buying for a lower cash price is not explicitly stated.[39]

This has given rise to the *hiyal* or fiction of the '*Ina* or double sale with 'mark ups', disguising a loan with interest. Here if A wishes to borrow $200 from B, to be repaid after six months, A will first approach C, from whom he will purchase an object (eg a watch) for the same amount which represents the borrowed capital plus the equivalent to western interest rate on a loan of a similar amount. In a hypothetical case, for example, it will be assumed that the interest would amount to $50 over the period. A watch will be supplied on credit, and payment date will be in six months time, which is equivalent to the time of repayment of the projected loan.

At this juncture, A will sell the watch to B for $200 cash payment and this cash can now be used by A for six months until it has to be paid, together with an extra $50, to C under the existing A – C contract. Now B sells the watch back to C for $250.[40] This is diagrammed below.



By this complex stratagem B acquires a $50 profit, ostensibly on the sale of a watch to C, but actually on the loan of $200 to A. C regains title to the 'sold' object, and A has had the use of the money as desired. Individually, each element is acceptable in form—a merchant may make a profit on the sale of an object, and objects may be sold on credit—but taken as a whole the transaction is clearly a device to covertly charge interest which could not be claimed overtly under Islamic law. The moral doubtfulness of the transaction is recognised by the Hanbali school, which condemns the whole transaction as void, but other schools range from complete acceptance (the Shafi'i), to reservations of a contract which is legally valid but morally disapproved (the Maliki).[41]

Another *hiyal* that is exceptionally popular with Islamic banks is the *murabaha* or 'cost plus' transaction, frequently used in Islamic letters of credit. This is designed

[39] See 'What is Usury?', above n 32, [23, 25-6].
[40] See Bellfonds 'Volonté Interne et Declarée en Droit Musulman', (1958) 3 *Revue International de Droit Comparé* 520, cited by Rayner, above n 13, 118.
[41] See Rayner, above n 13, 118-9.

to allow customers of a bank to obtain goods which they cannot immediately afford, and subsequently repay an amount effectively equal to the purchase price of the goods plus a mark-up equivalent to a charge for interest and bank costs. In this transaction the bank purchases the goods required by the customer, to whom it agrees to resell these at a price including a profit margin. The margin may be stated as a nominated amount or as a percentage of the purchase price, and all costs and prices involved must be known to the customer prior to entering into the contract. Ostensibly, the margin is earned by the bank by its efforts in locating, transporting and delivering the goods to the customer,[42] but with letters of credit, it is clear that the customer has in fact located the goods which are the subject of the credit, and that the transport will typically have been arranged by the original seller under a CIF contract, or by the buyer under an FOB contract. Delivery of shipping documents representing the goods in a CIF contract will indeed be by the bank, but this is a very routine facility for which standard charges—considerably less than the full mark-up under a *murabaha* transaction—are made, whilst delivery of the goods will normally be by the carrier or warehouse under its orders to the purchaser (bank customer) upon production of the bill of lading financed by the letter of credit.

Accordingly, as noted by some Islamic writers,[43] it is clear that the role of the bank is actually that of a financier, rather than of a handler and reseller of goods. Since the bank does not deal with the goods themselves but only with the provision of the cash necessary to obtain these, talk of a mark-up on the resale price of the goods is misleading. Yet if this is so, the implications for the *murabaha* mark-up are that it is actually a charge made for the use of money over time—essentially the definition of interest. As one theoretician of Islamic banking observed '[r]eplacement of interest by a technique like mark-up does not represent any substantive change.'[44]

Mansoor H Khan suggests that the reason for differentiating between interest charged on cash advanced for the use of the lender (which could be to purchase specific items such as housing loans in western financing) and the inclusion of what is in effect a 'cost-for-credit' component in credit sales is the fact that the latter involve 'real assets as opposed to financial assets. Islam assumes that by dealing in physical assets the parties take on themselves a risk of physical loss or destruction. *Because of this assumption of risk, the transaction passes the Islamic test.*'[45] This highlights another important aspect of *riba*—the fact that *riba* cannot co-exist with acceptable risk in the same contract. Only by taking acceptable risk can the making of profits be justified under this interpretation of Islamic commercial law.

In the devices employed to avoid *riba*, it is important to note that Islamic law has always been concerned to facilitate trade and ensure its fairness—hence the empha-

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[42] See Tarek el-Diwany, 'Modes of Finance' (1999) Islamic Finance, Arabic and Islamic Studies, <http://www.islamic-finance.com/item13.htm> (copy on file with author) [7].
[43] For example, Saeed, above n 35, 72 and el-Diwany, ibid [8].
[44] Zaiuddin Ahmad 'Towards Interest-Free Banking', cited by Saeed, above n 35, 73.
[45] Mansoor H Khan, 'Designing an Islamic Model for Project Finance' (1997) 16 *International Financial Law Review* 13 (Emphasis added).

sis on avoidance of *gharar*, which in its extreme form amounts to *maisir* or gambling. Islamic law in no way prohibits risk-taking per se, but looks rather to the cause of risk. Where this is due to lack of certainty in contractual terms or in one party's ability to deliver the subject matter of the contract due to lack of present ownership, the contract may be impugned for *gharar*. For example, it is not possible for A to contract to sell B a certain large trout currently swimming in a stream, since the trout may not be susceptible to being caught. Of course, it is possible to object that there is no absolute certainty in this world, since the continued future existence of the world or of any party to a contract cannot be guaranteed. However, in the continuum of risk from that which is acceptable to the unacceptable and condemned, unquantifiable risks outside human control appear to be disregarded.

On the other hand, some acceptable risk-taking is deemed to be a normal part of trading, justifying profits. Accordingly, where increase or gain can be attributed to reasonable risk-taking falling short of *gharar* and *maisir*, *riba* as unjustified gain is precluded. Indeed, it seems arguable that in the exchange of countervalues, the preparedness to run commercial risks by one party balances the return of profits by the other. If this is true, it highlights another anomaly—why should willingness to run risks in respect of the continued existence of tangible objects be qualitatively different from a willingness to run risks concerning the repayment of a sum of money? Whilst it is true that goods may be destroyed, they can, except in rare instances, be replaced, just as money lent can be replaced in specie. Indeed, in the latter case, the assumption is always that money will not be repaid in the identical notes originally lent.

The truth appears to be that two different kinds of risk[46] are here being confused—risk of physical destruction in the case of tangible goods, and risk of default by a borrower in the case of a loan. Presumably the essential difference between the two risks—the former, acceptable and justifying gain, the latter prohibited as *riba*—must lie in the perceived likelihood of the loss eventuating. The (unacceptable) risk of default may be seen as attributable to a vast variety of causes, from the physical death of a borrower or destruction of his or her assets, to dishonesty.

If this is the case, a solution may lie in Islamic insurance to reduce the risks run to commercially-acceptable levels. Insurance introduces a new feature, however, which is the possibility of reducing the risk of loss to the owner of goods or money from unacceptably high (entailing *gharar* or *maisir*) to negligible levels. If this is done, can there be any justification for the owner/lender taking any profit, since the justifying risk is now absent, and the profit converted conceptually to interest? Islamic banking is supposedly predicated on the concept of Profit and Loss Sharing ('PLS'), which further insulates gain from *riba*, since a gain based on sharing the commercial risk of loss is argued to be a gain bought for consideration, and so non-exploitative. Where the possibility of loss is offset by insurance to cover the loss

[46] In contradistinction to the different orders of risk referred to earlier—see above, Part II.F.

almost completely, can there be any real risk, and if not, will the gains now fall within the *riba* prohibition?

Abdullah Saeed has demonstrated that though Islamic banks often justify their mark-up in *murabaha* transactions as payment for the risks run in buying goods for resale to the customer (as an alternative to compensation for locating, transporting and delivering the goods), in reality there is virtually no risk involved.[47] Theoretically, under a *murabaha* sale, the bank bears the risk of loss or damage to the goods or of rejection by the buyer/customer from the time of purchase to the time of delivery, but in fact such risks are finessed by a contractual promise by the customer that he will not exercise his right under Islamic law to refuse to take delivery of the documents or the goods, that he will accept the goods in their current condition, that there is no vitiating uncertainty relating to the contract, and that he will not have recourse to the bank under any circumstances.[48] As if this were not enough, banks also may require customers to make advance payments sufficient to cover any possible loss in the event that the bank has to dispose of the goods due to default by the customer, and may require third party guarantees of the customer's performance, to negate the possibility of loss of profit to the bank.[49] Furthermore, if a defaulting client fails to pay a sum of money on time when it is within his or her capacity to do so, some banks will impose a fine which is related to the loss notionally sustained by the institution through being unable to lend out the money to another client, and is effectively the profit or interest lost on a new transaction.[50]

None of the foregoing suggests that Islamic banks actually run an appreciable risk of loss in *murabaha* transactions. Consequently, if the banks' charges cannot be justified by reference to the problems involved in physical handling of the goods (as there is none by the bank), then an appeal to risk to displace the possibility of *riba* as unjustified profit, or profit based on money lending, seems equally unsustainable.

Banks may also find themselves engaged in another transaction that bears a resemblance to some aspects of *murabaha*, and may involve *riba*, and this is *Ijara wa iqtina*. This is a lease of assets bought for the customer by the bank, together with an agreement to purchase the same at the end of the lease period,[51] with previously paid rental instalments forming part of the purchase price. Since there is a commitment to purchase from the inception, this amounts to a conditional sale, rather than a hire purchase agreement, where there is an option only to buy at the end of the lease period. The problem is that where, as is usual, the total instalment payments plus residual price exceeds the up-front price for the goods, the excess begins to look like a financing charge for the delayed payment. In other words, it is *riba* disguised by formalism to appear Islamically acceptable.

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[47] Saeed, above n 35, 66-70.
[48] Ibid 66-7.
[49] Ibid 67.
[50] Ibid 68.
[51] See el-Diwany, above n 42, 5.

B *Avoiding* Riba *May Still Be Ethically Dubious*

One means sometimes adopted to avoid the problem of *riba* is that of *mudarabah* or limited partnership between the bank and customer, whereby the former contributes cash, usually on a non-executive basis, and the latter contributes management, expertise, know-how, etc. The profits are divided in an agreed upon ratio, whilst losses are borne by the financier alone. This concept has been further extended to accommodate the issue of bonds and securities acceptable to the Islamic market. An investor puts money into a specific project, and receives bonds issued by the project director, which entitles him or her to share in profits earned in a *halal*, or Islamically acceptable, enterprise. Alternatively a person who has not selected any particular project in which to invest may put money into a *mudarabah* investment company which will select enterprises or portfolios designed to earn profit. This profit will be remitted to the holders of investment certificates on the date of their maturity.

This all sounds perfectly acceptable at one level, insofar as it does not involve *riba*, and profits accruing are distributed to risk-sharers, but at another level one has to ask whether these transactions are consonant with the principles of Islamic economics? These are supposed to uphold the view that wealth should not become monopolised by a few, but should circulate within society, reducing the gap between rich and poor.[52] However, it appears that the purchase of bonds and investment certificates will usually be made by persons with excess capital who are seeking to further increase this. An argument can certainly be made that investing money to gain more money is rather different from investing money in a plant to produce a product. If the distinction between the advance of credit for the purchase of goods, which is acceptable, and the payment of increase on money loans, which is forbidden, has any validity, its proponents should be aware that the same contention may militate against the purchase of bonds and securities.

Whether or not the foregoing distinction is accepted, there is still the further question of whether risk, by its mere presence, should legitimise a dealing by protecting against *riba*. It is possible for a commercial system to become fixated on avoiding certain forbidden elements, to the detriment of more positive tenets. The requirement of excluding *riba* by including acceptable risk sometimes appears to submerge the principle of economic equality underpinning Islam. Simple avoidance of *riba* may also prevail over the traditional concept that the use of money to produce material goods for the owner thereof (which are then traded for profit) is in some way more meritorious than the use of money to generate more money without its owner being involved in the actual disposition of intermediate goods.

Possibly one solution to this formalistic preoccupation with inclusion of theoretical risk lies in an acknowledgement of the different types of risk and an assessment of

[52] See Shadia Rahman, 'Islamic Accounting Standards' (1999) Islamic Foundation for Education and Welfare <http://www.ifew.com/insight/13036mon/accstds.htm> (on file with author) [5]. See also 'Islamic Issues', <:http://hudson.idt.net/~khal33/ISLAM.HTM> (on file with author) [4].

the reality of the risk for investors of loss of capital, as opposed to the risk of not receiving interest. If this can, by actuarial standards, be shown to be a low-eventuality risk, then arguably it could be discounted as being insignificant, opening the possibility that the transaction will generate *riba*.

More apparently suspect than the above-mentioned securities are zero-coupon bonds, which have gained popularity in Islamic financial markets. These are bonds that are purchased at below face value, since, unlike ordinary bonds with perforated coupons attached for presentation when interest is due, the holder will not be entitled to claim interest between the issue date and the date of maturity. When the time comes to redeem the bond, the full face value will be paid by the issuer. As a result of simply waiting, the holder makes a gain equal to the difference between purchase price and face value of the bond—a gain which appears to share many of the aspects of *riba*.[53] Once again, where there is concern to ensure that a commercial system is within the ethical parameters of Islam, arguments relating to the saving value of risk should be evaluated as statistical probabilities to ensure that the risk of non-repayment of the capital is significant.[54]

The aforementioned bonds and securities are predicated upon the *mudarabah* concept of partnership. An alternative form of partnership enterprise—*musharakah/shirak*—is more akin to a normal western partnership with losses being borne by all participants in proportion to their initial contributions, whether financial or in another form.[55] If *murabaha*, *ijara* and '*Ina* are impugned transaction under Islamic law, it is possible that there might be a much greater use of these partnership agreements.

Yet partnerships based on profit-and-loss sharing are clearly inappropriate for some transactions, notably those relating to consumer goods and housing loans, where the items are not purchased for the purpose of profit-making, but for the enjoyment of the borrower. Whilst Islamic economics discourages conspicuous consumption, there are few persons who do not require financial assistance to purchase major non-profit-making items such as a car and house. How could an ethically Islamic banking system deal with such financing needs? One approach has been to utilise the *bai bithamin ajil* transaction which is a form of *murabaha* applicable to tangible goods rather than to documentary intangibles such as letters of credit. However, this

[53] See 'What is Usury?', above n 32 [39-41].

[54] If these observations are true of the types of bonds and securities discussed, they may also have application with respect to the Western practice of discounting Bills of Exchange. In this, the holder of a term Bill of Exchange can immediately sell it at less than face value after liability has been accepted by the Drawee thereunder. The purchaser of the discounted Bill can either wait until the maturity date and receive the full value of the Bill upon presentation to the Drawee's bank, or on-sell the Bill to another holder in due course, who will pay a somewhat higher amount than the immediate seller, due to the reduced waiting time until the maturity date arrives. As with zero coupon bonds, this financial increase based on the lapse of time appears very close to *riba*, and given the rights under legislation of the holder in due course to sue either the Drawee or the Drawer of the Bill, as well as the commercial improbability, in many cases, of default occurring, the risk of actual loss to any Islamic purchaser/holder in due course may well be equivalent only to many other risks consequent upon daily life.

[55] See el-Diwany, above n 42, 7-8.

solution suffers from the same defects, ethically, as its mercantile counterpart.[56] Another possibility is that in countries where *zakat* (religious dues)[57] is collected by an official source, the funds so derived could be integrated with the banking system to provide interest-free loans for disadvantaged members of society. Against this is the fact that housing and other personal loans are not required only by the disadvantaged, to whom *zakat* may appropriately be extended, but also by blue-collar, middle class and wealthy citizens who do not fall into the *Qu'ranic* category of 'orphans, the needy, wayfarers in urgent need of money, beggars'.[58] It appears that Islamically acceptable attempts to circumvent this problem would have to be based on partnership concepts and on PLS, at the same time as avoiding the charge of empty formalism or contrived business undertakings.

V CONCLUSION

The initial question asked was whether or not an Islamic financial law system today can adhere to the ethical teaching of its founder, in a way that appears to be desired by the government of Pakistan. However, as noted, there are difficulties in determining the prescriptive moral content of these teachings, due to different schools of interpretation, the need to distinguish rational from non-rational components, differences in the levels of conceptualisation applied to various Islamic concepts and a degree of ambiguity in the connotations of some key original Arabic words. Nevertheless, it appears that the most intractable problems, commercially, centre around financing. It is significant that the legislation of many Islamic states recognises the right to impose a charge or interest on the use of money, despite the apparent condemnation of the religious jurists.

It would seem that sincere Muslims may need to consider first the moral essentials of this matter, and if these forbid any taking of interest, then they must decide whether such legislative 'finessing' of tenets of their faith is appropriate. If it is not, then a return to strict Islamic principles would be advisable, but necessarily adapting these principles to modern commercial conditions. Such adaptations may include reviewing the interdependence of risk and *riba* in the light of the prevalence of insurance, the taking of security and guarantees, pre-payments and liens over goods. Where there is no genuine or appreciable risk, it may be important to consider whether the transaction can be undertaken in this form, or whether alternative, complying methods of financing or dealing in commercial transactions must be developed. If the latter view is espoused, there will need to be a burgeoning of creative thought in the area of ethical Islamic financing, if Islamic commerce is to survive and not succumb to morally bankrupt formalism.

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[56] See 'What is Usury?', above n 32, [18-22].

[57] Usually at the rate of 2½ per cent of accumulated assets above the threshold level, but capable of extending to 20 per cent in circumstances where the input from the owner of the assets is minimal—the increase is attributed in large part to the workings of Allah—see Rahman, above n 52, [1-3 of appendix].

[58] Al-Baqarah, 2-177.