

Cambridge University Press

0521864143 - Islamic Finance: Law, Economics, and Practice

Mahmoud A. El-Gamal

Frontmatter

[More information](#)

---

## Islamic Finance

### Law, Economics, and Practice

This book provides an overview of the practice of Islamic finance and the historical roots that define its modes of operation. The focus of the book is analytical and forward-looking. It shows that Islamic finance exists primarily today as a form of rent-seeking legal arbitrage. An alternative that emphasizes substance rather than form would serve religious and moral objectives better, through mutual and similar financial practices.

Mahmoud A. El-Gamal is Professor of Economics and Statistics at Rice University, where he holds the endowed Chair in Islamic Economics, Finance, and Management. Prior to joining Rice in 1998, he had been an associate professor of Economics at the University of Wisconsin at Madison and an assistant professor of Economics at California Institute of Technology and the University of Rochester. He has also served in the Middle East Department of the International Monetary Fund (1995–6) and as the first Scholar in Residence on Islamic Finance at the U.S. Department of the Treasury in 2004. He has published extensively in the areas of econometrics, finance, experimental economics, and Islamic law and finance.

Cambridge University Press

0521864143 - Islamic Finance: Law, Economics, and Practice

Mahmoud A. El-Gamal

Frontmatter

[More information](#)

---

# Islamic Finance

## Law, Economics, and Practice

Mahmoud A. El-Gamal

*Rice University*



Cambridge University Press

0521864143 - Islamic Finance: Law, Economics, and Practice

Mahmoud A. El-Gamal

Frontmatter

[More information](#)

CAMBRIDGE UNIVERSITY PRESS

Cambridge, New York, Melbourne, Madrid, Cape Town, Singapore, São Paulo

Cambridge University Press

32 Avenue of the Americas, New York, NY 10013-2473, USA

[www.cambridge.org](http://www.cambridge.org)

Information on this title: [www.cambridge.org/9780521864145](http://www.cambridge.org/9780521864145)

© Mahmoud A. El-Gamal 2006

This publication is in copyright. Subject to statutory exception and to the provisions of relevant collective licensing agreements, no reproduction of any part may take place without the written permission of Cambridge University Press.

First published 2006

Printed in the United States of America

*A catalog record for this publication is available from the British Library.*

*Library of Congress Cataloging in Publication Data*

El-Gamal, Mahmoud A., 1963–

Islamic finance : law, economics, and practice / Mahmoud A. El-Gamal.

p. cm.

Includes bibliographical references and index.

ISBN 0-521-86414-3 (hardback)

1. Banking law (Islamic law). 2. Business enterprises – Finance – Law and legislation – Islamic countries. 3. Securities. 4. Finance – Religious aspects – Islam. 5. Economics – Religious aspects – Islam. I. Title.

KBP940.E45 2006

332.0917'67–dc22 2006005127

ISBN-13 978-0-521-86414-5 hardback

ISBN-10 0-521-86414-3 hardback

Cambridge University Press has no responsibility for the persistence or accuracy of URLs for external or third-party Internet Web sites referred to in this publication and does not guarantee that any content on such Web sites is, or will remain, accurate or appropriate.

Cambridge University Press

0521864143 - Islamic Finance: Law, Economics, and Practice

Mahmoud A. El-Gamal

Frontmatter

[More information](#)

---

*To  
Father  
& Mother,  
who taught me  
that religious forms  
should continually serve  
their central moral substance*

# Contents

<i>List of Illustrations</i>	<i>page</i> x
<i>Preface</i>	xi
<i>Glossary and Transliteration</i>	xv
<b>1 Introduction</b>	1
Finance without Interest?	2
1.1 Distinguishing Features of Islamic Finance	7
Prohibition-Driven Finance	8
Jurists, Shari'a Boards, and Innovation	11
Lawyers and Regulatory Arbitrage	13
1.2 Islamic Transactions Law as Common Law	15
Precedents, Analogies, and Nominate Contracts	17
Tradeoff between Efficiency and Legitimacy	20
1.3 Limits and Dangers of Shari'a Arbitrage	21
Risk of Mispricing	22
Legal and Regulatory Risks	23
<b>2 Jurisprudence and Arbitrage</b>	26
2.1 Islamic Law and Jurisprudence	27
The Canon: Qur'an, Tradition, and Consensus	27
Juristic Inference ( <i>Ijtihad</i> ) and Benefit Analysis	28
2.2 From Classical to Contemporary Jurisprudence	30
Jurisprudence, Revival, and Codification	31
Institution of <i>Fatwa</i> and Islamic Finance	32
2.3 Arbitrating Classical Jurisprudence	35
Shari'a-Arbitrating Classical Property Law	36
Arbitrating Classical Contract Conditions	42
Arbitrage, Ruses, and Islamic Finance	44

viii	<i>Contents</i>	
<b>3</b>	<b>Two Major Prohibitions: <i>Riba</i> and <i>Gharar</i></b>	46
3.1	The Prohibition of <i>Riba</i>	49
	Canonical Texts on <i>Riba</i>	49
	Economic Substance of the Prohibition of <i>Riba</i>	52
3.2	The Prohibition of <i>Gharar</i>	58
	Definition of <i>Gharar</i>	59
	Economic Substance of Prohibition	60
	Insurance and Derivatives	61
3.3	Bundled vs. Unbundled Credit and Risk	62
<b>4</b>	<b>Sale-Based Islamic Finance</b>	64
4.1	Basic Rules for Sales	65
	Trust Sales: <i>Murabaha</i> , <i>Tawliya</i> , <i>Wadi'a</i>	67
	Currency Exchange ( <i>Sarf</i> )	68
4.2	Same-Item Sale-Repurchase ( <i>Ina</i> )	70
	Same-Item Trading in <i>Ina</i> and <i>Tawarruq</i>	70
	Custody Sale ( <i>Bay' Al-'ubda</i> ) and <i>Sukuk Al-ijara</i>	73
4.3	Cost of Funds: Interest-Rate Benchmarks	74
	Opportunity Cost for Conventional Fund Providers	75
	Viability of Islamic Benchmark Alternatives	77
<b>5</b>	<b>Derivative-Like Sales: <i>Salam</i>, <i>Istisna'</i>, and <i>'Urbun</i></b>	81
5.1	Prepaid Forward Sale ( <i>Salam</i> )	81
	Parallel <i>Salam</i>	83
	Conventional and Synthesized Forwards	86
5.2	Commission to Manufacture ( <i>Istisna'</i> )	90
5.3	Down-Payment Sale ( <i>'Urbun</i> )	91
	<i>'Urbun</i> as Call Option	92
<b>6</b>	<b>Leasing, Securitization, and <i>Sukuk</i></b>	97
6.1	General Lease Conditions	97
	Flexible-Rate Financing	100
	Subleasing, Repairs, and Insurance Costs	100
6.2	Asset-Backed Securities	102
	Leasing and Securitization	102
	Receivable Securitization and Sale of Debt	104
	Bundling Asset-Based and Debt-Based Securities: A Paradox	106
6.3	Asset-Backed Leasing Bonds ( <i>Sukuk</i> )	107
	Credit-Rating Issues	108
	Reward Pledges and Gifts Revisited	110
6.4	Usufruct <i>Sukuk</i>	113
6.5	<i>Sukuk Al-Salam</i>	114

Cambridge University Press  
 0521864143 - Islamic Finance: Law, Economics, and Practice  
 Mahmoud A. El-Gamal  
 Frontmatter  
[More information](#)

	<i>Contents</i>	ix
<b>7</b>	<b>Partnerships and Equity Investment</b>	117
7.1	Classical Types of Partnership	117
	Silent Partnership: Theoretical Workhorse of Islamic Finance	120
	Valid and Defective Silent Partnerships	122
7.2	Common-Stock Ownership	123
	“Islamic Screens” and Their Shortcomings	125
	Cleansing Returns	133
	Positive Screens and the Islamic Brand Name	134
<b>8</b>	<b>Islamic Financial Institutions</b>	135
8.1	Banking and Islamic Banking	137
	Theoretical Structure: Two-Tier Silent Partnership	138
	Deposits vs. Loans: Trust and Guaranty	144
8.2	Insurance and <i>Takaful</i>	147
8.3	Two Sides of the Two Debates	151
	Shari’a Arbitrage vs. Islamic Prudential Regulation	152
8.4	Generic Agency Characterization of Financial Institutions	153
<b>9</b>	<b>Governance and Regulatory Solutions in Mutuality</b>	162
9.1	Rent-Seeking Shari’a Arbitrage and Absence of Mutuality	163
	Potential for Mutuality in Islamic Banking	166
	Need for Mutuality in <i>Takaful</i>	170
9.2	A Call for Mutuality in Banking and Insurance	171
	Mutuality in Banking	172
	Mutuality in Insurance	173
<b>10</b>	<b>Beyond Shari’a Arbitrage</b>	175
10.1	Shari’a Arbitrage and Criminal Finance	176
10.2	Shari’a Arbitrage at the Limit	177
	Benchmarking <i>ad Absurdum</i>	178
	Hedge-Fund Instruments – Shari’a-Arbitrage Style	180
10.3	Self-Destructiveness of Shari’a Arbitrage	181
	Declining Shari’a-Arbitrage Profit Margins	182
	Dilution of the “Islamic” Brand Name	183
10.4	Toward a New Islamic Finance Identity	184
	Macroeconomic Substance: Privatization <i>Sukuk</i>	185
	Mosque-Based Network of Financial Mutuals	186
	Positive Screens, Ethical Investment	188
	<b>Conclusion</b>	190
	<i>Notes</i>	193
	<i>Bibliography</i>	213
	<i>Index</i>	219

List of Illustrations

1.1	Home Mortgage Transaction	3
1.2	Juristic Characterization of Mortgage Loan	4
1.3	<i>Murabaha</i> Alternative for Home Finance	5
1.4	Tabreed <i>Sukuk</i> Structure	7
1.5	Prisoners' Dilemma	10
5.1	Forward Synthesized from <i>Salam</i> and Credit Sales	87
5.2	Al-Ahli Secured Fund Returns	94
5.3	Al-Rajhi Aman 1 Fund Returns	95
6.1	Structure of Qatar Global <i>Sukuk</i>	108
6.2	Structure of BMA <i>Sukuk Al-Salam</i>	115



Cambridge University Press

0521864143 - Islamic Finance: Law, Economics, and Practice

Mahmoud A. El-Gamal

Frontmatter

[More information](#)

## *Preface*

In recent years, financial activities conducted under the banner of “Islamic finance” have grown significantly in volume and scope, attracting significant attention worldwide. Numerous books and articles have been published on the topic over the past few decades. Their genres have ranged from highly religious treatises on Islamic law and worldview to highly practical surveys of the latest Islamic financial products to reach the market. Why, one must ask, should one read – let alone write – another book on the subject?

This book provides a qualitative overview of the practice of Islamic finance and the historical roots that have defined its modes of operation. The purpose of the book is not to survey the latest developments in this fast-growing industry. In the current information age, such information is best obtained on the Internet, since it requires updating at rates far exceeding the publication cycles of books and journal articles.

The focus of this book is analytical and forward-looking. I show that, despite the good intentions of its pioneers, Islamic finance has placed excessive emphasis on contract forms, thus becoming a primary target for rent-seeking legal arbitrageurs. In every aspect of finance – from personal loans to investment banking, and from market structure to corporate governance of financial institutions – Islamic finance aims to replicate in Islamic forms the substantive functions of contemporary financial instruments, markets, and institutions.

This supposed Islamization of contemporary financial practice is accomplished by means of modified premodern financial contracts (such as sales, leases, and simple partnerships). The contracts are designed by teams of (1) financial professionals who make and cater to the market for “Islamic” products, (2) lawyers who are skilled in the art of regulatory arbitrage, and (3) jurists or religious scholars who are familiar with medieval juristic texts (mostly in Arabic) and provide certification of the Islamicity of various financial products and services.

Cambridge University Press

0521864143 - Islamic Finance: Law, Economics, and Practice

Mahmoud A. El-Gamal

Frontmatter

[More information](#)

xii

*Preface*

To make the classical juristic literature (on which the industry is built) accessible to English-reading audiences, I have provided a translation of one of the most comprehensive surveys of classical Islamic jurisprudence and its contemporary understanding; see Al-Zuhayli (2003). The book in your hands contains the argument that the classical jurisprudence in that survey aimed mainly to enhance fairness and economic efficiency, subject to the legal and regulatory constraints of premodern societies. In this regard, many of the intended economic and prudential regulatory functions of classical contract conditions are currently served by other means that were made possible through advances in communication, legal structures, and information technology.

By attempting to replicate the substance of contemporary financial practice using premodern contract forms, Islamic finance has arguably failed to serve the objectives of Islamic Law (*maqasid al-Shari'a*): Wherever the substance of contemporary financial practice is in accordance with Islamic Law, adherence to premodern contract forms (with or without modification) leads most often to avoidable efficiency losses, thus violating one of the main legal objectives that defined classical Islamic jurisprudence. Conversely, by focusing on Islamicity of contract forms rather than substance (in part to justify efficiency losses), Islamic finance has often failed to serve the economic purpose for which certain premodern contract structures were codified in classical jurisprudence. This book provides multiple examples of both types of departure from serving Islamic legal objectives. The case is also made that form-oriented Islamic finance is not sustainable in the long term, because of (1) inherent dangers of using sophisticated structured finance methods in Islamic countries with relatively unsophisticated regulators and (2) competitive pressures that dictate convergence to efficient conventional financial modes.

I propose refocusing Islamic finance on substance rather than form. This would entail abandoning the paradigm of “Islamization” of every financial practice. It would also entail reorienting the brand name of Islamic finance to emphasize issues of community banking, microfinance, socially responsible investment, and the like. In other words, I argue that the “Islamic” in “Islamic finance” should relate to the social and economic ends of financial transactions, rather than the contract mechanics through which financial ends are achieved. I provide specific examples of areas where such reorientation of the brand name may in fact provide value to individual customers of the industry, as well as society more generally.

*A Note on Terms of Reverence*

It is customary in Islamic writings to use terms of reverence when significant religious figures are mentioned. For instance, mention of the Prophet is traditionally

Cambridge University Press

0521864143 - Islamic Finance: Law, Economics, and Practice

Mahmoud A. El-Gamal

Frontmatter

[More information](#)*Preface*

xiii

followed by the phrase “*ṣalla Allahu ‘alayhi wa sallam*” (may God bless him and give him peace), and the mention of his companions is traditionally followed by the phrase “*radīya Allahu ‘anhu*” (may God be pleased with him). However, Western academic writings conventionally eliminate the use of such terms of reverence. Following the latter convention, I shall not use terms of reverence in this book, as non-specialists and non-Muslims may find them distracting. In the meantime, I assure pious readers that I share their respect for all religious figures. I hope that they will not be offended by omission of printed terms of reverence, which readers may nonetheless vocalize at their discretion.

Mahmoud A. El-Gamal  
Houston, December 2005

Cambridge University Press

0521864143 - Islamic Finance: Law, Economics, and Practice

Mahmoud A. El-Gamal

Frontmatter

[More information](#)

## Glossary and Transliteration

*Allāh* – God.

*amāna* – trust, possession of.

*‘aqd* – contract.

*bātil* – invalid (contract).

*bayʿ* – sale.

*bayʿ al-amāna* – variation on same-item sale-repurchase (*‘īna*).

*bayʿ al-‘īna* – same-item sale-repurchase.

*bayʿ al-kālī bi-l-kālī* – trading one deferred obligation for another, forbidden based on a tradition with questionable authenticity.

*bayʿ al-‘uhda* – variation on same-item sale-repurchase (*‘īna*).

*bayʿ al-wafāʾ* – variation on same-item sale-repurchase (*‘īna*).

*bayʿ bi-thaman ājil* – credit sale.

*companion* – immediate follower of the Prophet.

*ḍamān* – guaranty, possession of.

*ḍarar* – harm or injury.

*dayn* – debt or liability for fungible property.

*dīnār* – Roman gold coins, adopted as currency in early Islam.

*dirham* – Persian silver coins, adopted as currency in early Islam.

*fāʾida* – (literally: benefit) interest, plural *fawāʾid*.

*fāsid* – defective (contract).

*fatwā* – religious edict or opinion, plural *fatāwā*, anglicized plural *fatwas*.

*fiqh* – juristic understanding or inference based on Shariʿa.

*fuḍūlī* – uncommissioned agent.

*gharar* – risk or uncertainty, forbidden if excessive and avoidable.

*ḥadīth* – report of Prophetic or other early Islamic tradition.

*Ḥanafī* – belonging to the juristic school of Abū Ḥanīfa, see note 24, Chapter 2.

*Ḥanbalī* – belonging to the juristic school of Aḥmad ibn Ḥanbal, see note 24, Chapter 2.

Cambridge University Press

0521864143 - Islamic Finance: Law, Economics, and Practice

Mahmoud A. El-Gamal

Frontmatter

[More information](#)

xvi

*Glossary and Transliteration***hiba** – gift.**hijra** – the Prophet's migration from Makka to Yathrib (later called Madina).**ḥīla** – ruse, legal stratagem to circumvent various prohibitions, plural *ḥiyal*.**ḥukm Sharʿī** – Islamic legal status ruling.**īdāʿ** – fiduciary deposit contract.**ījāra** – lease or hire contract.**ijmāʿ** – juristic consensus.**ijtihād** – juristic inference.**ʿilla** – juristic reason or grounds for analogy.**iqāla** – contract revocation.**istiḥsān** – juristic approbation, to overrule juristic analogy.**istiṣlāḥ** – benefit analysis, to overrule juristic analogy.**istiṣnāʿ** – commission to manufacture.**Jamāʿat-i-Islāmī** – Islamist party founded by Pakistani writer Abu Al-Aʿlā Al-Mawdūdī.**jiʿāla** – pledge to make payment.**jurist** – *faqīh*, a specialist in Islamic jurisprudence.**kafāla** – guaranty offered on behalf of some party.**Mālikī** – belonging to the juristic school of Mālik ibn Anas, see note 24, Chapter 2.**manfaʿa** – usufruct of a property.**maqāṣṣa** – mutual debt clearance.**maṣlaḥa** – public or private benefit, plural *maṣāliḥ*.**muḍāraba** – silent partnership.**muftī** – jurist who issues *fatwā*.**murābaḥa** – cost-plus sale, often combined with *bayʿ bi-thaman ājil*.**Al-Ikhwān Al-Muslimūn** – Muslim Brotherhood, Islamist group founded by Egyptian teacher Hassan Al-Banna.**qarḍ** – loan of fungible property.**qirāḍ** – silent partnership.**qiyās** – juristic inference by analogy.**Qurʾān** – ultimate Islamic canon, believed to be the revealed word of God.**rahn** – collateral or pawned property in lieu of debt.**ribā** – major prohibition of Islam, similar but not equivalent to either usury or interest, see Chapter 3.**ribawī** – property subject to the rules of *ribā*.**ṣakk** – bond or certificate, plural *ṣukūk*.**salam** – forward sale with prepaid price.**sanad** – bond or certificate, plural *sanadāt*.**ṣarf** – currency exchange contract.

Cambridge University Press

0521864143 - Islamic Finance: Law, Economics, and Practice

Mahmoud A. El-Gamal

Frontmatter

[More information](#)

*Glossary and Transliteration*

xvii

***Shāfiʿī*** – belonging to the juristic school of Muḥammad ibn Idrīs Al-Shāfiʿī, see note 24, Chapter 2.

***Sharīʿa*** – revealed divine law in Qurʾān and *Sunna*.

***sharika*** – partnership, see Chapter 7 for various types.

***ṣukūk*** – bonds or certificates, plural of *ṣakk*.

***Sunna*** – Prophetic or other early Islamic tradition.

***tabarruʿ*** – voluntary contribution.

***takāful*** – mutual guaranty or insurance, used differently in Islamic finance, see Chapter 8.

***takhrīj fiqhī*** – juristic recharacterization of a contract or transaction (usually forbidden) in terms of another (usually permissible).

***tawarruq*** – three-party variation on *bayʿ al-ʿīna*.

***tawliya*** – sale at cost.

***ʿurbūn*** – down payment on purchase, from which call options are routinely synthesized.

***ʿurf*** – customary practice, appeals to which may overrule juristic analogy.

***wadīʿa*** – fiduciary deposit.

***wadīʿa*** – sale below cost.

***wakāla*** – agency.

***waqf*** – trust or mortmain, plural *awqāf*.

***zakāh*** – obligatory Islamic wealth tax.