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.

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To
Father
& Mother,
who taught me
that religious forms
should continually serve
their central moral substance
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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.
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
followed by the phrase "olla Allahu 'alayhi wa sallam" (may God bless him and give him peace), and the mention of his companions is traditionally followed by the phrase "radiya 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
Glossary and Transliteration

Allāh – God.
amāna – trust, possession of.
‘aqd – contract.
bātūl – invalid (contract).
bayṣ – sale.
bayṣ al-amāna – variation on same-item sale-repurchase (‘īna).
bayṣ al-kāli` bi-l-kāli` – trading one deferred obligation for another, forbidden based on a tradition with questionable authenticity.
bayṣ al-‘uhdā – variation on same-item sale-repurchase (‘īna).
bayṣ al-wafā` – variation on same-item sale-repurchase (‘īna).
bayṣ bi-thaman ājil – credit sale.
companion – immediate follower of the Prophet.
dāmān – guaranty, possession of.
dārar – 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.
fā’ida – (literally: benefit) interest, plural fawā’id.
fāsid – defective (contract).
fatwā – religious edict or opinion, plural fatwāwā, anglicized plural fatwas.
fiqh – juristic understanding or inference based on Shari’a.
fudālī – uncommissioned agent.
gharar – risk or uncertainty, forbidden if excessive and avoidable.
ḥadīth – report of Prophetic or other early Islamic tradition.
Hanafi – belonging to the juristic school of Abū Ḥanīfa, see note 24, Chapter 2.
Hanbali – belonging to the juristic school of ʿAṣmaḍ ibn Ḥanbal, see note 24, Chapter 2.
hiba – gift.

hijra – the Prophet’s migration from Makka to Yathrib (later called Madina).

hila – ruse, legal stratagem to circumvent various prohibitions, plural hijāl.

ḥukm Shar‘i – Islamic legal status ruling.

idā – fiduciary deposit contract.

ijārā – lease or hire contract.

ijmā‘ – juristic consensus.

ijtihād – juristic inference.

illa – juristic reason or grounds for analogy.

iqāla – contract revocation.

istiḥān – juristic approbation, to overrule juristic analogy.

istiṣlah – benefit analysis, to overrule juristic analogy.

istiṣnā – commission to manufacture.

Jamā‘ at-i-İlāmi – Islamist party founded by Pakistani writer Abu Al-A‘lā Al-Mawdūdī.

ji‘āla – pledge to make payment.

jurist – faqih, a specialist in Islamic jurisprudence.

kašāla – guaranty offered on behalf of some party.

Malikī – belonging to the juristic school of Malik ibn Anas, see note 24, Chapter 2.

manfa‘a – usufruct of a property.

maqāṣsa – mutual debt clearance.

mašāba – public or private benefit, plural maqāšib.

muḍāraḥa – silent partnership.

muftī – jurist who issues fatwā.

murābaha – cost-plus sale, often combined with bay‘ bi-thaman ājil.

Al-Ikhwān Al-Muslimūn – Muslim Brotherhood, Islamist group founded by Egyptian teacher Hassan Al-Banna.

qard – loan of fungible property.

qirād – silent partnership.

qiyās – juristic inference by analogy.

Qur‘ān – ultimate Islamic canon, believed to be the revealed word of God.

rahb – 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 ṣakāk.

salam – forward sale with prepaid price.

sanad – bond or certificate, plural sanadāt.

sarf – currency exchange contract.
Glossary and Transliteration

Shafi’i – belonging to the juristic school of Muhammad ibn Idris Al-Shafi’i, see note 24, Chapter 2.

Sharīa – revealed divine law in Qur’an and Sunna.

sharīka – partnership, see Chapter 7 for various types.

ṣukūk – bonds or certificates, plural of ṣakk.

Sunna – Prophetic or other early Islamic tradition.

tabarru’ – voluntary contribution.

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

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

tawarruq – three-party variation on ba‘y al‘ina.

tawiliya – sale at cost.

‘urbūn – down payment on purchase, from which call options are routinely synthesized.

‘urf – customary practice, appeals to which may overrule juristic analogy.

wadā’a – fiduciary deposit.

wadi’a – sale below cost.

wakāla – agency.

waqf – trust or mortmain, plural awqāf.

zakāh – obligatory Islamic wealth tax.