Islamic Finance and Dispute Resolution: Part 1

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Abstract
The Islamic Financial Industry is an industry that organises financial services in accordance with Islamic Law, in the same way as the traditional financial industry is organised in accordance with secular law. The unique challenges facing the industry in terms of compliance with Islamic law have been internationally recognised in relation to capital adequacy, risk management, corporate governance, transparency and disclosure. The same, however, has not been true in the area of dispute resolution. The purpose of this paper is to identify the unique challenges facing Islamic finance in compliance with Islamic law in the ambit of English courts, evaluate the features of international commercial arbitration as they relate to overcoming these challenges, and provide some suggestions for going forward. The paper is structured as follows: Section 1 will be used to introduce Islamic finance and frame the issues facing the industry in relation to dispute resolution. Section 2 will focus on providing the background required, while Section 3 frames Islamic finance in relation to conventional finance. Section 4 will provide an insight into Islamic law.

Keywords
Contract law; conventional finance; dispute resolution; financial intermediation; international commercial arbitration; Islamic finance; party autonomy

1. Introduction
This section will first introduce the topic of Islamic finance and the problems that may come to face the industry in terms of dispute resolution.

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The potential issues facing the industry, in regard to the resolution of disputes, will be framed within the context of two decisions: one made in the ambit of the English courts and the other through arbitration.

In today's increasingly competitive business environment, to thrive, or even to survive, requires not only the intricate alignment of a complex array of information, operations, and logistics, but also requires ready access to cost effective financing. Providing the required financing is the objective of financial intermediation.

Often, there exists more than one way by which to reach an objective and nowhere is this more true than in the area of financial intermediation, where two alternate structural paths, designed to reach the same objective, now stand side by side—conventional finance and Islamic finance. Although Islamic modes of financing have been in practice in one form or another since the early history of Islam, as an industry, Islamic finance has been essentially dormant from the late nineteenth century through the recent past. Not until the later part of the twentieth century did the Islamic financial

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1 In support of efficient business operations, all business must secure financing to support needs for working capital (inventories, salaries), assets (i.e. property, equipment, research) and sales (consumer credit). See Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion Risk, and Return*, The Hague, (Kluwer International Law) 1998.

2 'At the core of any financial industry is structuring a process by which those who have money and those who need money find each other and organize their relationship.’ Mohamed El-Gari, presentation at the conference; Islamic Finance: Relevance and Growth in the Modern Financial Age, London School of Economics, 1 Feb 2007.

3 With the exception of Iran and Sudan where banking is legislated to be 100% Islamic, in the countries where Islamic financial products are made available, they are usually provided in conjunction with conventional finance.

4 Throughout the Middle Ages, Islamic merchants became indispensable middlemen for fostering trade through development of sophisticated credit instruments in Spain, the Mediterranean and Baltic states. See Zuhair Iqbal and Hiroshi Tsubota, “Emerging Islamic Capital Markets: A Quickening Pace and a New Potential” in *The Euromoney International Debt Capital Handbook, (Euromoney Yearbooks)* 2006, pp. 134-140. In addition, Islamic modes of financing were also seen to be the method of choice in funding trade in the Ottoman Empire: 'Even though there did not exist an insurmountable barrier against the use of interest-bearing loans for commercial credit, this alternative was not pursued in the medieval Islamic world. Instead, numerous other commercial techniques were developed which played the same role as interest-bearing loans and thus made the use of loans unnecessary.’ See Sevket Pamuk, ‘The Evolution of Factor Markets in the Ottoman Empire, 1500-1800’, presented at the Global Economic History Network Workshop on The Rise, Organization and Institutional Framework of Factor Markets, 2005.
industry experience a resurgence—a resurgence, which although initially slow,\textsuperscript{5} picked up to a dramatic pace in the early part of the twenty-first century.\textsuperscript{6}

The resurgence and exponential growth experienced in Islamic finance in the past few years is of particular note as it not only serves to increase the breadth of financial product offerings\textsuperscript{7} on the international scene, it is also making—intentionally or unintentionally—a decidedly positive contribution in bridging the current chasm between the West and Islam; a chasm that was until recently thought by some to be insurmountable.\textsuperscript{8} Hence, the need to ensure continued stability and growth of this industry is no longer a concern unique to those who may have been the catalyst for its resurgence,\textsuperscript{9} but rather should be a concern that is shared by all players.\textsuperscript{10} A precondition to sustainable development of any financial industry is a suitable regulatory framework, which includes an effective dispute resolution mechanism.\textsuperscript{11}

\textsuperscript{5} The resurgence of the industry was marked in the 1960s by the inauguration of only two institutions: the Mit Ghamer Bank that opened in Egypt in 1963, and the Tabung Haji Bank, which opened in Malaysia in 1967. See, Islamic Research & Training Institute, Islamic Development Bank and Islamic Financial Services Board, The Islamic Financial Services Industry, Ten-Year Master Plan (2006-2015), 2005.

\textsuperscript{6} Today there are over 250 institutions operating in over 75 countries, with a market size estimated at 750 billion and said to be growing at an annual rate of 15-20%. See Iqbal Khan, presentation at the conference; Islamic Finance: Relevance and Growth in the Modern Financial Age London School of Economics, 1 Feb. 2007.

\textsuperscript{7} For general overview of the breadth of product offerings in the Islamic financial industry, see generally supra, note 1, Ch. 6, and The Middle East Times, October 2006, p. 33.

\textsuperscript{8} See, generally, Samuel P. Huntington, Clash of Civilizations Remaking of World Order, New York (Touchstone) 1997.

\textsuperscript{9} The resurgence of Islam finance was primarily driven by Muslims that viewed the flight into Islamic banking as a direct means by which society could revive an abandoned commercial tradition. As noted by Professor Mallat, the advocacy was seen to run along the following lines: ‘let’s go back to the tradition in is pure form, get rid of interest, and establish a riba-free Islamic banking system’; see Chibli Mallat, ‘Commercial Law in the Middle East: Between Classical Transactions and Modern Business’, 48 Am. J. Com. Law, 2000, pp. 81-142.

\textsuperscript{10} As noted by William Blair QC: ‘If a bank fails, it make no difference to the depositors whether it is an Islamic or non-Islamic bank, the result is the same. They lose their money, and confidence in the financial system as a whole is damaged.’ See, William Blair, Key Note Speech: ‘Legal Issues in the Islamic Financial Services Industry’, Kuwait City, 1-2 March 2005. <http://www.3vb.com/pgs-members/m_wblair.shtml>.

Islamic finance, which, as the name implies, is financial intermediation accomplished in a manner that is firmly rooted in the Islamic principles articulated in the Shari‘ah,\textsuperscript{12} and, as such, requires that:

Practitioners create products that simultaneously satisfy the demands of secular and religious laws, in much the same way as they must look to the laws of two or more jurisdictions in structuring a cross-border transaction.\textsuperscript{13}

Up-front compliance with Islamic law is verified by Shari‘ah boards,\textsuperscript{14} and is required as a condition precedent to contract. But, as demonstrated in the following cases, it appears that the role of Islamic law, which is arguably the law, or one of the laws, with the closest connection to Islamic finance contracts, may, depending on the selected forum, be diminished during the dispute resolution process.

**Case:** Two contracts concerning Islamic financial transactions, similar governing law clauses, but differing fora. The first providing for arbitration, while the second providing for English courts. Disputes ensued. Juxtaposing the outcomes of the resolution of these two disputes may serve to highlight the flexibility of arbitration in addressing disputes arising under Islamic finance agreements, while serving to highlight the limitations in the ability of the English courts to apply Islamic law.

In the first case, which pertained to an *Estisna*\textsuperscript{15} financing arrangement between International Investor KCSC (Kuwait) and Sanghi Polyester Ltd. (SPL),\textsuperscript{16} arbitration was the dispute resolution mechanism of choice, and

\textsuperscript{12} The Shari‘ah, which literally means “the path”, and its role in Islam and Islamic law is further discussed in Section 4, *infra*.

\textsuperscript{13} Thomas C. Baxter, Jr., Executive Vice President and General Counsel of the Federal Reserve Bank of New York, Statement before the Seminar on Legal Issues in the Islamic Financial Services Industry, Kuwait City, 2 March 2005.

\textsuperscript{14} Islamic financial institutions employ a committee of Islamic jurists that study the proposed financial transaction, and issue an opinion as to the compliance of the transaction to Islamic law in the form of a *fatwā*, which is a non-binding jurist’s opinion.

\textsuperscript{15} Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good (or premise) at a given price on a given date in the future. The price need not be paid in advance. It may be paid in installments in step with the preferences of the parties or partly at the front end and the balance later on as agreed. See, *supra*, note 5, vii.

\textsuperscript{16} Sanghi Polyesters Ltd (India) v The International Investor KCSC (Kuwait) [2001] C.L.C. at 748.
the terms of reference of the arbitration confirmed the place of arbitration as London and the “applicable substantive law” as:

This dispute shall be governed by the Laws of England except to the extent it may conflict with Islamic Shari‘ah, which shall prevail.

The decision of the arbitrator, an expert in Islamic law, as expressed in an ICC Arbitration Award obtained in London, gave effect to the parties’ will to be governed by English law, except where this would conflict with Shari‘ah, by awarding principal and the profit claims, but disallowing additional damages claims because, although compliant with English law, these would conflict with Islamic Shari‘ah.

In the second case, a *Morabaha* financing agreement between a Bahraini bank and a Bangladeshi pharmaceutical group, the decision of the English court, in interpreting the governing law clause:

Subject to the principles of Glorious Shari‘ah this agreement shall be governed by and construed in accordance with the laws of England.

found the proviso “Subject to the principles of the Glorious Shari‘ah” to be inadequate to fulfil the purpose of incorporating the principles of Shari‘ah law into the parties’ agreements, deeming that the governing law of the contract is simply English law and held accordingly. Although this holding failed to ensure compliance with the mandatory principles of Shari‘ah as was the apparent intention of the parties, it was upheld by the English court of appeal and welcomed by some in the legal profession as adding certainty.

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17 Ibid., at 750.
18 Ibid., at 749.
19 Sale at a specified profit margin contract. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in installments or in a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. See, supra, note 5, vii.
21 Ibid., p1, para 5. In addition, this is the type of governing law clause identified by Vogel and Hayes ‘as a compromise position’. See supra, note 1, 51.
One finds that the decision made within the ambit of the English courts, the well established forum of choice in international financial transactions, both for legal certainty and speed, by trading off “certainty of Shari‘ah compliance” for “financial commercial certainty”, served to, render the use of the term “Islamic” in Islamic finance as a mere attempt to draw a distinction, without there being a real difference between Islamic and conventional financing. On the other hand, one finds that the arbitral decision gave meaning to the term “Islamic” in Islamic finance by ensuring compliance with Shari‘ah.

Was this English court holding case unique, or do the heteronomous restrictions on the parties’ autonomy within the ambit of English courts expose the parties to the risk of violating the mandatory provisions of Shari‘ah, which form the fundamental pillars on which Islamic finance transactions are built? If so, then, to what extent?

Was the arbitral decision unique, or do the inherent features of arbitration provide for more flexibility in terms of rendering decisions that are in line with the expectations, intentions, and will of the parties than do national courts when it comes to the application of Islamic law as an applicable law of contract? If so, can international commercial arbitration play a positive role in overcoming the limitations posed by English courts in the resolution of disputes relating to Islamic financial transactions? More specifically, do the features of international commercial arbitration readily lend themselves to giving meaning to the term “Islamic” in Islamic finance by ensuring compliance with the mandatory provisions of Shari‘ah, a non-national law, in the dispute resolution phase?

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24 H.L.E. Verhagen, ‘The Tension between Party Autonomy and European Union Law: Some Observations on Ingmar Gb Ltd V Eaton Leonard Technologies Inc.’, ICLQ, 51/1 (2002) 135. In addition, discussion with legal representatives involved in the Islamic financial industry support the conclusion that adoption of a dispute resolution clause that includes English Courts as the forum and English law as the governing law continues to be a not unusual approach in Islamic financial transactions.

25 In banking and financial transactions in particular legal certainty is a paramount consideration and the certainty that this choice brings is highly prized by the contractual counterparties and English lawyers alike. Foreign parties often agree to the application of English law applied by the English courts on their understanding that when they select English law what they provide for in the contract is usually all that they get See Stuart Dutson, ‘The Law Applicable To Contracts: Amendments To Undermine Common Sense And The Attractiveness Of European Courts’, JIBFL, 7 (2006) 300.


27 Supra, note 22.
The purpose of this paper is to attempt to answer these questions by examining both, the limitations that may be posed on the English courts that prevent giving effect to Islamic law as a governing law of contract within the dispute resolution process and the advantages that could flow from selection of arbitration as the dispute resolution forum in the sphere of Islamic finance.

Before commencing this examination, not only must background sufficient to allow for an understanding of Islamic financial intermediation and its commercial purpose be provided, but also the nature of Islamic law and its implications must be addressed. As such, Sections 2-4 are reserved for this purpose.

2. Background

In this section, sufficient background is presented as to allow for the contextual understanding of the Islamic financial industry, both in terms of its history and its unique legal requirements.

Notwithstanding that the number of years which represent the history of Islamic finance are large in magnitude, a state of dormancy for the majority of the twentieth century has cast Islamic finance in the role of a “developing industry” in the current sphere of global finance. As Dr. El-Ahdab noted, the development of law often follows the development of a

28 Although solutions within the context of the English courts, or alternate national forum, may also be possible to address the current potential violation of mandatory provision of Shari’ah through the selection of English courts as the forum of choice in Islamic finance contracts, I leave the identification and evaluation of those solutions to those more learned than I. The intent of this current work is only to address the possibility of the forum of international commercial arbitration as a viable solution.

29 Islamic finance can be traced back to the 12th century and provided the main support structure for financial transactions during the Ottoman Empire. See, generally, Joseph J. Spengler, ‘Economic Thought of Islam: Ibn Khaldun’, Comparative Studies in Society and History, Vol. 6/3 (1964) 268-306; and Pamuk, supra, note 4.


new industry as to provide the supporting legal framework designed to address the new concerns that arise from the operation of the new industry:

It has become usual to note the evolution of law over the years and also the development of existing rights or the appearance of new regulations, which reflect the new needs for the national and international society.

For example, during the 17th and 18th centuries, maritime law developed as a result of the development of this kind of commerce. Similarly, during the 19th century the doctrine of objective liability appeared following the industrial revolution and the appearance of machines and, finally, the 20th century has seen the appearance of a new kind of law, Air Transport Law, because of the arrival of this new form of transportation and the problems which result therefrom.

To date, a global Islamic finance law, although likely to be available in the future, has not yet been developed.\textsuperscript{32} To sustain the exponential growth experienced in the area of Islamic finance, both in terms of volume\textsuperscript{33} and diversity,\textsuperscript{34} requires, as noted by Dr. Akhtar, Governor of the Central Bank of Malaysia in 2004, during the 3rd Annual Islamic Finance Summit, that the legal infrastructure, including the area of dispute resolution, be customised to accommodate the unique features of Islamic finance:

\ldots precondition to sustain the continued growth of Islamic banking and finance is a comprehensive legal infrastructure for legal redress arising from Islamic financial transactions. The legal infrastructure needs to comprise both effective regulatory and substantive laws as well as appropriate adjudicative fora for parties to resolve disputes relating to Islamic financial transactions. To address this, efforts are needed to develop a sufficient number of competent lawyers and judges that are equipped with sound knowledge and expertise in both Shari'ah and civil laws to deal with such matters.\textsuperscript{35}

\textsuperscript{32} Although many countries have either developed separate Islamic banking laws, or modified their current banking regulations to include Islamic bank specific regulations, there is no “Islamic Finance Law” that can be readily applied as the governing law of contract in national courts.

\textsuperscript{33} Currently, there is 750 billion USD under investment in Islamic finance, see supra, note 6.

\textsuperscript{34} Although the industry was launched to serve the needs of Muslim, and the initial growth experienced was experienced in predominately Muslim countries and institutions, today many of the participants include traditionally secular institutions such as HSBC, and CitiBank. See Middle East Times, supra, note 7; and BBC News, “Islamic Finance: From Niche to Mainstream”, 23 March 2007, <http://news.bbc.co.uk/2/hi/business/6483343.stm>.

Despite much progress,\textsuperscript{36} which may have been broader in countries with strong Islamic tradition,\textsuperscript{37} an approach of “customisation to meet the needs of the Islamic finance industry” has not been taken in secular courts. This may be due to a lack of flexibility by secular courts in the accommodation of religious law.

This lack of flexibility in the accommodation of religious law appears to have underpinned the English court’s failure to give effect to the mandatory principles of Shari’ah, the foundational pillars on which Islamic finance is built, in their decision relating to the \textit{Beximco case}.\textsuperscript{38}

Vogel and Hayes noted, as early as 1998, the pivotal nature of applying a governing law other than Islamic law in Islamic finance contracts:\textsuperscript{39}

\ldots Islamic law does not allow recovery of lost profits, seeing such claims as both speculative and unearned. But a national law may award such damages, even against a losing party’s protest that the contract is ‘Islamic’. Note also that if the parties have agreed on terms that are questionable under Islamic law but allowed under local law… the local legal system will almost certainly enforce it… enabling parties to… evade Islamic law.

It is against this background that one may begin to understand why the limitations, currently imposed by the selection of English courts as the dispute resolution forum for contracts designed to be simultaneously

\textsuperscript{36} Although secular countries have also undertaken some legislative reforms, these have been primarily in the tax arena. For example the UK has, since 2003, undertaken legislation to ensure non-biased tax treatment of Islamic finance products. Currently there exists legislation enabling the use of Islamic financing methods for an individual or business to finance a property purchase, bank deposits and borrow money from a financial institution. Similar regulatory changes are now under consideration for the issue of ‘sukuk’ (the Islamic finance equivalent of a bond). For a discussion of UK initiatives before 2006, see Qudeer Latif, ‘Islamic Finance’, \textit{JIBFL}, 1/10, 1 January 2006. For discussion pertaining to \textit{sukuk}, see, generally, Speech by the Economic Secretary to the Treasury, Ed Balls MP at the London Islamic Financial Services Summit, 29 March 2007, \texttt{<http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/econsecspeeches/speech_est_290307.cfm>}.  

\textsuperscript{37} In countries that have a strong Islamic tradition, such a Malaysia, much legal reform has been instituted to address the specific needs of the Islamic finance industry both in the areas of legislation and adjudication. See Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, opening remarks at the Third IFSB Seminar on ‘Legal Issues: Surveys on Legal & Shari’ah Issues in the Islamic Financial Services Industry’, Kuala Lumpur, 28 March 2007, \texttt{<http://www.bis.org/review/r070413c.pdf>}.  

\textsuperscript{38} \textit{Supra}, note 22.  

\textsuperscript{39} \textit{Supra}, note 1.
compliant with both secular and religious laws, may compel some participants in Islamic finance to search for a forum—such as arbitration—that may prove more conducive to furthering, rather than defeating, the commercial purpose of Islamic finance.

To evaluate whether arbitration possesses the inherent features that would render it more conducive to accommodating the dispute resolution needs of Islamic financial transactions, an adequate understanding of the commercial purpose of the Islamic finance must first be developed.

Attempting to develop an adequate understanding of the commercial purpose of Islamic finance, without looking through the appropriate prism that allows one to develop such an understanding within the proper context, would be, in essence, trying to gain an understanding of a subject matter in a vacuum. As such, in an effort to construct the prism that will be effective in elucidating the “commercial purpose” and salient aspects of Islamic finance, we borrow from Lord Wilberforce’s dictum in Reardon Smith,40 and extrapolate to an industry level:

> In a commercial contract it is certainly right that the court should know the commercial purpose of the contract and this in turn presupposes knowledge of the genesis of the transaction, the background, the context, the market in which the parties are operating.41 [emphasis added]

Hence, equipped with background, before turning to evaluating arbitration as an effective dispute resolution alternative, sufficient foundation, as to allow for an understanding of the Islamic finance as an industry, in the context of its origins, must first be provided. The following two sections provide this foundational framework. Section 3 will cover Islamic finance within the context of financial intermediation and Section 4 will be reserved for a discussion on Islam and Islamic law, its schools and spectrum of interpretations, prohibitions and possibilities.

### 3. Islamic Finance and Financial Intermediation

The purpose of this section is to begin to provide the foundational framework required by presenting a view of Islamic finance within the context of global financial intermediation. It is also the intent of this section to

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41 Ibid., at 996.
highlight the main differences that distinguish Islamic finance from conventional finance.

As previously noted, the principal role of a financial industry is to provide financial intermediation by structuring a process by which those who have money and those who need money find each other and organise their relationship of exchange for the benefit of all parties.

In any financial transaction, there must be at least two parties; the owner/supplier of the funds, the “Depositor”, and the party in need of funds to make an investment, the “Borrower”.

[Diagram: Saver of Funds (The Depositor) to User of Funds (The Borrower)]

Typically, in any transaction, there is also a third entity that makes the transaction between the two parties possible, the “Intermediary”. The main role of the intermediary in the financial industry is providing savers with a means by which to effectively use their surplus funds—the “Deposits”, and to provide the investor ready access to these pooled deposits.

[Diagram: Source of Funds (The Saver) to Financial Institution (The Intermediary) to User of Funds (The Borrower)]

Success of the financial transaction is measured from the depositor’s point of view in terms of liquidity and return, and from the borrower’s point of view in terms of availability and cost of funds. Hence, optimisation of the intermediary’s returns rests squarely on effectively pooling the resources of the depositors, and efficiently utilising these resources to generate positive returns by making these funds available to the borrowers.

In two-party transactions, namely those transaction precluding the intermediary, the options are limited. The saver can either lend the funds to the borrower or can share in the investment through some sort of partnership mechanism.

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42 Supra, note 2.
The role of the financial intermediary is to increase the number of options available to both primary parties, the depositors and the borrowers, by increasing the range of viable financial instruments available to accomplish their saving and borrowing needs. The role of intermediary is performed through both banking and non-banking institutions.

Although the requirement for financing is a universal one, shared by people of all walks of life and all faiths, the means by which they accomplish financial intermediation is what varies. Two such systems that are designed to provide financial intermediation are conventional finance and Islamic finance.

In conventional finance, the basic building block in financial intermediation is an interest-based transaction, in which the saver is guaranteed a rate of return for the use of their funds, and in which borrower receives access to the funds in the form of debt, to be repaid on a date certain, in the form of principle plus interest. The transactions in this process are both discrete, and at arm’s length, with the only risk assumed by the depositor is for the insolvency of the intermediary, or the borrower—the debt must be paid back regardless of the success or failure of the ultimate investment, and is often guaranteed by third parties.

This interest-based approach to financial intermediation is rendered invalid by the doctrinal teachings of Islam. Two prohibitions in the doctrinal teachings of Islam, namely the prohibitions of *riba* and *gharar* essentially render any interest-based transaction invalid. Hence, Islamic finance is designed to provide Muslims a means by which they can meet their present-day financing needs, within the context of their religious values. Islam adopts the view that, unlike the approach that maintains a separation between Church and State, the material and the spiritual are inextricably linked, and both are guided by the Shari‘ah, which literally means “the path”.

This in no way implies that Islamic finance, like its conventional counterpart, is not driven by market forces in an effort to attain efficiency and optimise returns. Indeed, it is, but simply stated, it just must do so within the bounds of those overarching constraints imposed by the mandatory

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43 In the case that there is no intermediary, then the insolvency of the investor may put the saver at risk.
44 For a discussion on the *riba*, see infra, Section 4.1.1.
45 For a discussion on *gharar*, see infra, Section 4.1.2.
46 Matthew, XXII, 16-18 leave to ‘Caesar what is Caesar’s and leave to God what is His’.
principles of Islamic law relating to commercial transactions.\textsuperscript{48} Thus, these constraints, simply serve to limit the means by which Islamic finance accomplishes financial intermediation to gaining returns from investment activities and other operations that generate extra wealth, such as asset-backed trade.\textsuperscript{49}

Islamic financial intermediation is viewed as a partnership in which all participants risk and share in both the profits and the losses, requires ensuring that compliance with Shariʿah is maintained throughout the lifecycle of the Islamic finance—not only in the collection and pooling of available funds, but also through investment and distribution of returns. This view represents a paradigm shift from conventional finance; in which it is the returns, rather than the means by which the returns are obtained, that are sought to be secured. Hence, although the objectives of both systems are ostensibly the same, conventional and Islamic finance differ in one major way, in that the former guarantees depositors certain return, while the later guarantees the process, rather than the return.

Consequently, not only must each individual financial transaction in Islamic finance simultaneously satisfy the demands of secular and Islamic law, but this duality must also be respected by all transactions involved in the entire Islamic financial intermediation process lifecycle. Simply stated, the mosaic of contracts used to accomplish Islamic financial intermediation must be viewed as a chain, in which Shariʿah compliance must be maintained for all transactions within the financial intermediation process lifecycle in order for the ultimate returns to be compliant; meaning that if one transaction within the chain is tainted with \textit{riba} or \textit{gharar}, that would render the entire process non-Islamic and would require that the returns are cleansed\textsuperscript{50} or purified from income earned from non-permissible activities.

\textsuperscript{48} In addition to \textit{riba} and \textit{ghara}, trade must not include trade in assets by which are prohibited by the Shariʿah, such as alcohol or pork products. For further elaboration on the prohibitions, see \textit{infra}, Section 4.

\textsuperscript{49} \textit{Supra}, note 1, 198.

\textsuperscript{50} Cleansing is mechanism to purify investments that are tainted by prohibited activities. The cleansing process is normally performed by the individual investors, although, in some cases, the Islamic funds would perform the task on behalf of their investors. For instance, if some part of the income from interest-bearing accounts (prohibited by Shariʿah) is included in the income of the company, the proportion of such income in the dividend paid to the shareholder must be given to charity, and must not be retained by the shareholder. See \textit{Islamic Capital Market Fact Finding Report}, Islamic Capital Market Task
Notwithstanding this intricate complexity, the search for simplicity has led some, in light of the obvious prohibitions, to simply use the term “interest-free”51 in conjunction with Islamic finance. But, as Zamir Iqbal of the World Bank, clearly points out:

Describing the Islamic financial system simply as “interest-free” does not do justice to the system. Promotion of entrepreneurship, preservation of property rights, transparency and the sanctity of contractual obligations, which are crucial to any sound financial system describe the essence.52

Understanding Islamic finance within this context—a current-day financial industry that is inextricably linked to the principles of Islam—first requires an understanding of Islam.

4. Islam—the Religion and the Law53

The origins and structure of Islamic finance are firmly rooted in the scriptures of Islam,54 one of the three great monotheistic religions.55 As such, this section focuses on providing a glimpse into the religion of Islam and its law, in an effort to lay the foundation for understanding how and why the religion of Islam precipitated the growth of an alternative financial industry. Albeit that a detailed analysis of Islam is outside the scope of this work, a brief look is nonetheless warranted so as to understand the genesis of this unique system of finance that has now come to be commonly referred to as “Islamic Finance”. The discussion will start by focusing on the religion, and will then turn to providing insight as the areas of Islamic law that specifically impact Islamic finance.

52 See Iqbal, supra, note 4.
53 The discussion of aspects of Islamic law presented here are by necessity brief, and are thus neither intended to be without exception or qualification, but are simply intended to provide the framework for elaboration of the mandatory provisions that impact Islamic financial transactions.
54 Supra, note 1, 1.
55 With Christianity and Judaism being the other two.
The advent of Islam\textsuperscript{56} gave the peoples of seventh-century Arabia a new identity—an identity based on faith, rather than one based on tribal affiliation. In so doing, Islam essentially served to awaken a conscience of a people, and transformed a person’s primary loyalty from the tribe to God.\textsuperscript{57} It is the duty of all Muslims to submit to God’s Will, as articulated in Shari’ah.\textsuperscript{58} The Shari’ah, which is formed by the combination of the Qur’ān\textsuperscript{59} and the Prophetic Sunnah,\textsuperscript{60} is the divinely ordained pattern of human conduct,\textsuperscript{61} governing all aspects of a people’s relationship with their maker, as well as their relationship between themselves and others, and categorising all human acts within one of the following five categories: (1) \textit{wāgib} (obligation); (2) \textit{mandūb} (recommended); (3) \textit{mubah} (permitted); (4) \textit{makrūh} (disapproved/disliked); and (5) \textit{hāram} (forbidden/prohibited).\textsuperscript{62}

Although the Qur’ān is explicit in a number of places regarding obligations and prohibitions, in general it is more expressive in terms of the purpose, rationale and benefit of its laws.\textsuperscript{63} Qur’ānic legislation differs from

\textsuperscript{56} Islam came as a revelation to Prophet Muhammad in the year 610 AD. The pre-Islamic period is often referred to as the “jahiliyyah”, which many define as the period of ignorance, but Karen Armstrong argues that recent study shows that the Prophet used the term “jahiliyyah” to refer to a state of mind that caused violence and terror in 7th century Arabia. See Karen Armstrong, \textit{Muhammad, A Prophet For Our Time}, New York (Harper-Collins) 2006.


\textsuperscript{58} “The path” is the literal translation of the Arabic term “Shari’ah”.

\textsuperscript{59} The Qur’ān, the sacred scriptures of the Muslims, is viewed by Muslims as the words of God and, as is pointed out by Armstrong, the language of the Qur’ān, as is the case with the Jewish scriptures, represents the sacred words in someway spoken by God himself. She further points out that the Qur’ān, which literally means “recitation” (as Muhammad could neither read nor write), is written in a language so exquisite, and of such beauty, which so moves and stirs people and serves to further fuel their belief that the words could only come from God. See, \textit{supra}, note 56, 57.

\textsuperscript{60} The Prophetic Sunnah is the collection of Hadith and examples of the Prophet. According to Shafī’i in his \textit{Risala}, the Prophetic Sunnah serves to prescribe what God has revealed in the Qur’ān, and it explains the general principles of the Qur’ān and clarifies the will of God; and it is also where the Prophet has ruled on matters on which the Qur’ān is silent.


\textsuperscript{62} \textit{Supra}, note 1, 41.

\textsuperscript{63} The Shari’ah is generally predicated on benefits to the individual and the community, and its laws are designed so as to protect these benefits and to facilitate the improvement and perfection of the conditions of human life on earth and \textit{Rahmah} (mercy or compassion) is considered by the ‘Ulama (scholars) to be its all-pervasive objective. ‘Adl (justice) is
legal codes in form, because as a rule the Shari‘ah does not “state” the law in a strictly legal sense, but rather articulates a system of “oughts” and “ought-nots” from which the “law” must be extracted or derived.

It is from this foundation that one begins to understand that the Shari‘ah itself is not law, but undoubtedly, the Qur‘ān along with the Prophetic Sunnah, constitute the sources from which Islamic law can be derived, with primacy of place given to the Qur‘ān, which is then followed by the Sunnah. The process of extracting or deriving legal rules from its sources requires human effort and is termed “ijtihād”.

Hence, in Islamic Jurisprudence (fiqh), the distinction between law and its sources is carefully maintained. The law is a product of ijtihād—standing at the end of the interpretative process. Although ijtihād will result in the jurist “opinion” as to what the law is, ijtihād is by no means a subjective process; it is rather an objective process that employs a particular

the manifestation of God’s mercy which seeks to establish equilibrium between rights and obligations so as to eliminate all excess and disparities in all spheres of life. See Mohammad Hashim Kamali, Principles of Islamic Jurisprudence, Kuala Lumpur (Ilmaiah Publ.) 1999.

Ansari, supra, note 57.

Supra, note 61, 83.


In legal usage, ijtihād refers to the endeavor of jurist to formulate a rule of law on the basis of evidence (dal‘i‘i) found in the sources. See generally supra, note 66, 200.

Ibid., 199-203.

Notwithstanding, it is important to note that the jurists do not create law, rather the jurist’s task is that of elucidating and formulating legal rules from that which is present in the sources, but not always self-evident.

Islamic law has been called a “jurists’ law”. This description is apt if it is used to express the idea that only the jurists are in a position to discover the Law of God and, having discovered it, to state authoritatively what the Law is. To the extent that the Law of God may be found at all in the mundane realm, it is only found in the formulations of jurists. It is primarily by virtue of the ijtihād of jurists that Islamic law exists at all as a body of positive rules. See supra, note 66, 201.

Ibid., insofar as subjective factors enter into juristic deliberations, the results are to be
methodology. The methods and principles that govern *ijtihād* are collectively known as *ʾusūl-al-fiqh.*

The subject of *ʾusūl-al-fiqh* was expounded upon by Mohamed Ibn Idris Al-Shafiʿi in the *Risala.* The following passages elucidate the salient points in Al-Shafiʿi’s *Risala* as it relates to *ʾusūl-al-fiqh.* As noted by Hallaq, Al-Shafiʿi begins by defining the sources and the methods by which God communicates his message within the Shariʿah:

Muslims are duty-bound to attempt to gain and augment *ʿilm,* that is knowledge of the scripture in its direct as well as oblique meanings. For God has revealed His precepts in a variety of forms. In one form, He unequivocally states in the Qurʾān certain rulings, such as those related to prayer, alms-tax, pilgrimage, fasting, etc. In another form, the rulings are stipulated in the Qurʾān in general terms, the details of which the Prophet has laid down in his Sunnah. God has also decreed certain rulings through his Prophet, without there being any reference to them in the Qurʾān. Finally, the revealed texts, the Qurʾān and the Sunnah, provide, in the absence of explicitly formulated rulings, indications and signs (*dalalāt*) which lead to the discovery of what God intended the law to be.

Al-Shafiʿi then goes on to explain that, in the cases where the Shariʿah explicitly states the legal rules, then the legal rules, without modification, are the law. But, when the sources are not explicit, Al-Shafiʿi states that a jurist must employ *qiyaṣ* in extracting what they believe to be Islamic law:

Obviously, when the Book or the Sunnah provides the legal solution to a particular problem, no inference is needed. But when there arises a new case for which the texts

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73 Supra, note 1, 32.
74 For a good introduction to *ʾusūl-al-fiqh,* see Kamali, *supra,* note 63, 1-13.
75 *Al-Risala* is widely acknowledged as the first work of authority on *ʾusūl-al-fiqh.* For an instruction to Islamic jurisprudence see, e.g., Kamali, Mohammad Hashim. *Principles of Islamic Jurisprudence.* Kuala Lumpur (Ilmaiah Publ.) 1999.
77 Supra, note 67.
78 Qiyaṣ is defined ‘analogical reasoning, concluded from a given principle or is similar to this precedent on the strength of a common essential feature called the reason (*ʿilla*)’, see Rahman, *supra,* note 61. Where *ʿilla* is ‘the underlying principle or objective of a Shariʿah injunction’ see Nabil Saleh, ‘Law Governing Contracts Law in Arabia’, *ICLQ,* 38/4 (1989) 762.
provide no express solution, the exercise of *ijtihād* becomes not only necessary but obligatory. In the absence of a formulated textual solution, the jurist must look for a parallel textual case for which a solution is provided. If the new case has the same *ratio legis* (*ma'na*; lit. meaning) as that given to the parallel textual case, the ruling in the text must be transferred to the new case. But such a *ratio legis* is not always capable of identification, in which event the jurist must locate all cases in the texts that resemble the new case, and must transfer the ruling of the most similar case to the new case at hand. These two methods, one based on a *ratio legis*, the other on a similitude, are together with the *a fortiori* argument, the exclusive constituents of *ijtihād* (*=qiyās*). Any inference that is governed by less than the strict implications and significations of the texts is invalid and hence impermissible.79

Thus, making it clear that in the case of ‘*ilm*, where the sources are explicit, the sources are the law and are mandatory. But, in the cases where the sources are not explicit and leave room for *ijtihād*, then Islamic jurisprudence allows for “disagreement” or difference (*ikhtilāf*)80 of opinion between qualified jurists.81 In the case where *ijtihād* results in consensus (*ijma*’) on a given point amongst qualified jurists of an age,82 the ruling has a binding and absolute authority. While it is the doctrine of *ijma*’ that provides an authoritative umbrella for Islamic law, it is the doctrine of *ikhtilāf* that gives authoritative foundation to the variant schools of theory (*madāhib*) in Islamic law.83 It is important to note that there are two main sects in the religion of Islam, Sunni and Shi’a. While *ikhtilāf* in legal


80 *Ikhtilāf* is often explained and justified by the following alleged dictum of the Prophet Muhammad: ‘Difference of opinion within my community is a sign of the bounty of Allah’. In addition, this is also one of the reasons that Muslim jurisprudence insists very strongly that the results of *ijtihād* be classified as *zann*, or opinion, and that *zann* be carefully distinguished from ‘*ilm*, or knowledge because the notion of opinion suggests possibility of error an inevitable fact of legal life and is implicit in *ikhtilāf* among the jurists. See Noel Coulson, *Conflict and Tensions in Islamic Jurisprudence*, Chicago (University of Chicago Press) 1969, p. 20.

81 In the *Risāla*, Al-Shafi’i identifies the following as requirements of a jurist to be considered “qualified” to perform *ijtihād*: Knowledge of Arabic, Knowledge of the legal contents of the Book, and its general and particular language, knowledge of the theory of abrogation (*naskh*), must be able to employ the Sunnah in interpreting those Qur’anic verses that are equivocal, and in the absence of a Sunnah he must be aware of the existence of a consensus which might inform the case at hand. Further he must have attained majority, be of sound mind, and willing and ready to exert his utmost intellectual effort in solving the case.

82 *Supra*, note 1.

83 *Supra*, note 80, 23-24.
doctrine is crystallised in Sunni Islam by the existence of four madāhib, Shi’a Islam does not accept this premise.84 The four schools of Sunni Islam

84 It is import to note that while in Islam there are two main sects, the Sunni and the Shi’a, this paper is only addressing Sunni Islam. While it is beyond the scope of this paper to address Shi’a Islam in detail, it is thought to be helpful to point to the three differences between the Sunni and Shi’a Twelver or Imami tradition as identified by Bernard Weiss:

One difference between the two communities is their conception of which sources may be used in deriving rules. Both the Sunnis and the Shi’as accept the Koran and the Tradition of the Prophet as sources of law, although each community has its own collection of prophetic material as well as its own notion of true revelation. Both communities believe in an infallible source of truth after the age of the Prophet, but they differ as to its identity. For the Sunnis, this further source of truth is the Consensus of the Community, which, although it consist largely of the consensus of earlier generations of Muslims (particularly that of the Companions of the Prophet), is supposed to contain the contemporary consensus on a continuing basis. For the Twelver Shi’is, the twelve infallible Imams (spiritual guides) of the Community, as descendents of the Prophet’s cousin and daughter, are accepted as a continuing source of truth. Consensus must include the infallible Imam, and because the Imam’s pronouncements are correct whether included in a consensus or not, the importance of consensus in the Shi’i theory of sources of truth is minimal.

A second difference between the two communities is their attitude toward human intuition (ʿaql) as an independent source of law. Sunni Islam does not recognize human intuition as valid source of law. Consequently, it maintains an absolute dependence upon the sacred texts. Among Sunni jurists, God alone is the ultimate determiner of all rules of human conduct (and because the ethical and the legal are not separated in Islam, of all moral values). The obverse of this is that the human intellect, without revelation, is incapable of distinguishing between right and wrong. This incapacity exists because right and wrong exist solely by virtue of divine command, and because divine command is considered to be beyond the reach of the unaided human intellect. In Shi’i Islam, on the other hand, divine command and human intellect are complementary; right and wrong are the common postulates of both revelation and reason.

The recognition in Shi’i jurisprudence of the competence of human intellect points to a third important difference. Generally speaking, Shi’ism places a higher premium on knowledge than does Sunni Islam. Consequently, Shi’ism displays a more cautious attitude toward opinion. Because intuition is recognized as a valid source of ethical—legal values, legal knowledge is considered to be more within the reach of man in Shi’i tradition than it is in Sunni tradition. Shi’ism affirms a functional bond between sacred text and rational intuition which helps to safeguard man from uncertainty. Furthermore, by positing the infallible doctrine of the Imam, Shi’ism increases the wellsprings of truth. In contrast to the consensus—which, by its very nature, is indefinite—the word of the Imam is concrete and historically verifiable, like the Sunna of the Prophet. In fact, the word of the Imam is incorporated into a more comprehensive Sunna, that of the Prophet cum Imam, unlike the Sunni Consensus which has always remained
are the Maliki, Hanafi, Hanbali, and Shafi’i. Although each individual Muslim is free to follow the school of their choice, Islamic nation states have each traditionally followed a particular madhab (school). For example, Hanafi law has traditionally been applied in that area of the Middle East now covered by Turkey, Syria, Lebanon, Iraq, Jordan, Egypt, the Sudan, and in the Indian subcontinent, while Maliki law has governed the Muslim populations in North, West, and Central Africa and Shafi’i law has prevailed in East Africa, the southern part of the Arabian Peninsula and in Southeast Asia. Hanbali law is today the law of the land in the kingdom of Saudi Arabia. With the exception of Hanbali law, which is codified as the law of the Kingdom of Saudi Arabia, and the Hanafi law, which was codified as part of the Tanzimat undertaken by the Ottoman Empire, the majority of Islamic fiqh is documented in the works of the jurists, and is written in classical Arabic.

distinct from the Sunna. Thus, not only does Shi’ism recognize more sources of divinely given truth than does Sunni Islam, but it also acknowledges a greater capacity of the human intellect to derive legal knowledge.

Nonetheless, Shi’i tradition does not altogether disregard opinion as a basis of law. Although it may be able to distinguish between right and wrong, the human intellect is not considered to be entirely capable of perceiving the specific requirements of divine law, particularly in the realm of worship. Consequently, the sacred texts (including the sayings of the Imams) remain an indispensible source of law. And no text, however sacred, is so unambiguous that it does not require some interpretation. Consequently, opinion is a necessary part of the law in Shi’ism.

But opinion is carefully circumscribed in Shi’i jurisprudence. Ikhtilaf—plurality of legal schools (madāhib)—is disallowed. The ideal of a single, uniform body of truth is piously upheld. The principle restriction upon the exercise of opinion is a rejection of qiyās, or analogical reasoning, which is a basic tool of interpretation in Sunni Islam. Shi’i jurisprudence does not allow opinion to exceed the confines of the actual meaning of a text. It regards reasoning by analogy as too conjectural, too subjective. The Shi’i theorist maintains that one can never give adequate objective grounds for affirming a thing to be the true ratio (‘illa) of a given rule, unless the ratio is clearly stated in the text (mansūs alayhā), in which case there is no real analogical reasoning from the text, but rather a simple declaration of what is found in the text.’

See supra, note 66, 211-212.

85 Supra, note 80, 24.


Islamic jurisprudence, related to the governing of human interaction is divided into three areas: (1) Domestic relations; (2) Punishment; and (3) Civil obligations. The section that governs civil obligations is known as *fiqh al-mu’amalāt*. Thus, further discussion of *fiqh*, will be limited to that of *fiqh al-mu’amalāt* and only as it relates to the subject of commercial transactions.


While it is beyond the scope, or purpose, of this section to deal with aspects of *fiqh al-mu’amalāt* in an exhaustive manner, it is important to gain insight as to certain pivotal aspects of this topic in relation to being governing law of contract in commercial transactions. Further, sources of prohibitions pertaining to Shari‘ah compliant commercial transactions, their treatment, and their impact on Islamic financial transactions will also be discussed.

In Islam, commerce and trade are not only condoned, they are encouraged:

Q45:13: ‘And He has subjected to you, as from Him all that is in the heavens and on earth: behold…’

Q4:29: ‘O ye who believe! Eat not up your property among yourselves in vanities: But let there be amongst you traffic and trade by mutual good will…’

Trade was encouraged (Q4:29), and parties were free to trade in all that was created by God (Q45:13), with the only limitations being those of trade in that which was specifically prohibited by God:

Prophetic Sunnah: ‘The *ḥalāl* (permissible) is what is permitted by God in His book and what is *ḥaran* (prohibited) is what is forbidden by God. What God does not mention is of what is condoned.’

Further, trade was required to be accomplished within a certain legal framework, namely, commercial transactions were to be governed by contract,

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89 All Qur’anic verses are indicated using the following notations *Sūrah:Āya* (chapter: verse), hence 45:13 means Āya 13 of *Sūrah* 45. All quotations from the Qur’an, unless otherwise noted, are from Abdullah Yusuf Ali, “The Holy Qur’an”, (English translation), Beirut (Dar Al-Arabia).

90 For example, in addition to *riba* and *gharar*, it would also be prohibited to trade in alcohol and pork, which are also specifically prohibited.
and the parties were to be governed by the principles of good faith.\textsuperscript{91} The following verses from the Qur’ān elucidate these principles:

Q5:1: ‘O believers! Fulfil (all) obligations\textsuperscript{92}

Q17:34: ‘Give full measure when ye measure, and weigh with a balance that is straight…’

In addition, although not imperative, it was highly recommended that commercial transactions be reduced to writing:

Q2:282: ‘O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time reduce them to writing let a scribe write down faithfully as between the parties: Let not the scribe refuse to write: as God has taught him, so let him write. Let him who incurs the liability dictate, but let him fear his Lord God, and not diminish aught of what he owes. […] Disdain not to reduce to writing (your contract) for a future period, whether it be small or big: it is juster in the sight of God, more suitable as evidence, and more convenient to prevent doubts amongst yourselves, there is no blame on you if ye reduce it not to writing, but take witnesses whenever ye make a commercial contract; and let neither scribe nor witness suffer harm.’

‘\textit{Aqd al-bay}’ (contract of sale), as may be expected in a commercial legal system that was designed to support trade,\textsuperscript{93} serves as the model from which Muslim jurists extrapolated all other contract types.\textsuperscript{94} It also served as the source of specific rules governing each type of transaction.\textsuperscript{95} Given that, as indicated earlier, a general maxim of contract in Islamic law is ‘all is permitted unless specifically prohibited’, further discussion of the general prohibitions is warranted, as these rules and principles will permeate the fabric of all contracts constructed in accordance with the principles of Islamic law.

Compliance with the pivotal aspects of Shari’ah in Islamic finance is at times understood by some to simply be the accommodation of a few specific legal restrictions, namely, prohibiting the use of transactions that include \textit{riba} or \textit{gharar}. While the prohibitions are real, they are neither


\textsuperscript{92} As noted, obligations include both spiritual and material, with the material including commercial contracts.

\textsuperscript{93} For succinct presentation of the centrality of trade in Islam see Mallat, \textit{supra}, note 9.

\textsuperscript{94} Ibid., Mallat terms the contract of sale the ‘paragon’ of all contracts in Islamic law.

\textsuperscript{95} For general overview of Islamic contract law, see generally \textit{supra}, note 1, Ch. 5.
exhaustive, nor is their application simple. While the principle of freedom of contract is recognised by Islamic law, it is restricted by certain prohibitions. These prohibitions include not only riba and gharar, but also other prohibitions that are often not mentioned, that must be considered, as the lack of compliance with such prohibitions may render a contract void. One such prohibition, found in the Hanafi and Shafi‘i schools, is that which prohibits the inclusion of multiple transactions within one contract.  

Moreover, the depth of detail by which Islamic jurisprudence treats these prohibitions infuses a complexity that, although not insurmountable, renders simply extracting a few basic rules to follow, as to ensure Shari‘ah compliance, at best insufficient.

As such, the sources and treatment of the prohibitions related to riba and gharar are presented in turn, and then followed by a discussion of those aspects that may also serve to further restrict the parties’ freedom to contract.

4.1.1. Riba

There is ijma‘ amongst Islamic jurists on the prohibition of riba, which has been explicitly prohibited in the Qur‘ān in several places, with the earliest chronological prohibition being that found in Surā 30:39. Despite ijma‘ regarding prohibition of riba, ikhtilāf regarding the definition of riba is found amongst the maḏāhib.

Riba, which etymologically means “excess” or “increase,” is not defined in the Qur‘ān, and is expressed in more than one sense in the Shari‘ah; namely riba al-jahiliyyah, riba al-nasi‘ah, and riba al-fadl.

Riba al-jahiliyyah, which is used to denote the type of riba in use during the Jahiliyyah period, the period before the advent of Islam, was specifically prohibited in the Qur‘ān.

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97 Supra, note 1, 28-29 and 44-45.
99 Supra, note 47.
100 Supra, note 98, 698.
101 Although riba al-jahiliyyah is a type of riba al-nasi‘ah, it is classified separately to denote that it was the type of riba practiced before the advent of Islam.
102 During the period of jahiliyyah, riba was excessive; an extension in the period of the debt resulted in doubling, and redoubling, the amount of the debt. See, supra, note 1, 61.
Q3:130: ‘O ye who believe! Devour not Usury, Doubled and multiplied; but fear God; that Ye may (really) prosper.’

_Riba al-nasi‘ah_ is used in the sense when *riba* is associated with gain from the trade of like goods in which the gain results from the passage of time. For example, when the like good is money, in which debt is paid back at some later date in the form of principle-plus guaranteed increase—interest charged on a loan is _riba_. Whereas, _riba al-fadl_ is used when the gains are obtained through the instantaneous exchange of like goods—the difference in measure or weight is considered _riba_.

The sources of prohibition of both _riba al-nasi‘ah_ and _riba al-fadl_ can be found in the following Qur’anic verses:

Q2:275: ‘Those who devour usury will not stand except as stands one whom the Evil One by his touch hath driven to madness that is because they say “trade is like usury”, but God hath permitted trade and forbidden usury . . .’

Q2:276: ‘God will deprive usury of all blessing . . .’

Q2:278-79: ‘O you who have attained to faith! Remain conscious of God, and give up all outstanding gains from usury, if you are [truly] believers for if you do it not then know that you are at war with God and His Apostle. But if you repent, then you shall be entitled to [the return of] your principle: you will do no wrong, neither will you be wronged.’

But specifying the forms of _riba_, which are the subject matter of the prohibitions, took place through the Prophetic Sunnah.105

Gold for gold, like-for-like,106 hand-to-hand, and the excess is _riba_. Silver for silver, like-for-like, hand-to-hand, and the excess is _riba_. Wheat for wheat, like-for-like, hand-to-hand, and the excess is _riba_. Salt for salt, like-for-like, hand-to-hand, and the excess is _riba_. Barley for barley, like-for-like, hand-to-hand, and the excess is _riba_. Dates for dates, like-for-like, hand-to-hand, and the excess is _riba_. If the kinds differ, sell as you like as long as it is hand to hand.107

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103 Fostering entrepreneurship is one of the rationales for prohibition of _riba al-nasi‘ah_ in that it prevents the entrepreneur from getting crushed in adverse conditions. See M. Umer Chapra, _The Nature Of Riba In Islam_, <http://rufatedu.castel.az/islam/IRTI%20Course%202006/Chapra3.pdf>.

104 Supra, note 98, 74.

105 Supra, note 96, 196-97.

106 “Like” as used herein refers to both type and quantity.

107 Supra, note 96, 196-97.
As noted by El-Sanhouri, this Hadith has helped to define usages of the term *riba* as it relates to the prohibitions in the Qur’ān by establishing that which is *ribawi* (*riba*-related).\(^{108}\) and the type of exchange of such goods that would constitute *riba*.\(^ {109}\) Namely, the exchange of goods of a single type without equality constitutes *riba al-fadl*, and exchange among the *ribawi* goods, with delay, constitutes *riba al-nasi‘ah*.\(^ {110}\) The preceding discussion serves to shed some light on the prohibition on *riba*, and to give insight as to why *ikhtilāf* amongst the Islamic jurists may exist, and that notwithstanding, the scope of the *ikhtilāf* may vary, certain nuances must be noted when attempting to structure financial transactions that are Shari‘ah compliant.

4.1.2. *Gharar*

There is *ijma* amongst Islamic jurists that *gharar*\(^ {111}\) is prohibited by the Shari‘ah and the source of that prohibition is contained in the following Qur’ān verses:\(^ {112}\)

\[
\text{Q2:90-91: 'O ye who believe! Intoxicants and gambling, (dedication of) stones, and (divination by) arrows, are an abomination, of Satan's handiwork; eschew such (abomination) that ye may prosper. Satan's plan is (but) to excite enmity and hatred between you, with intoxicants and gambling, and hinder you from the remembrance of God, and from prayer: Will ye not abstain?'}
\]

Although the prohibition of *gharar* was only expounded upon in relation to trade in the Sunnah, two forms of activity depending on chance were specifically named in the above verses; namely gambling, representing the extreme form of that which depends on chance, and (divination by) arrows.\(^ {113}\)

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\(^{108}\) There is *ikhtilāf* between the various *madāhib* regarding the extent to which this Hadith can be used to extract, by *qiyās*, that which is *ribawi*. For further discussion on this point see, *supra* note 1, 75; and *supra*, note 96, 200-8.

\(^{109}\) Hadith as cited by El-Sanhouri, *supra*, note 96, 196-97.

\(^{110}\) A later Hadith, that reported that the Prophet purchased on credit, permitted delayed sales as long as currency is one of the two goods exchanged. See *supra*, note 1, 74.

\(^{111}\) Although *gharar* is often defined as “risk”, see Mahmoud El-Gamal “An Economic Explication Of The Prohibition Of Gharar in Classical Islamic Jurisprudence”, 2001 (<http://www.ruf.rice.edu/~elgamal/files/riba.pdf>), a definition thought to be more salient in conveying the essence “gharar” is “aleatory” which is defined as that depending on chance or contingency, or conditioned on uncertain events. See Harith Suleiman Faruqui, *Faruqui’s Law Dictionary Arabic–English*, Beirut (Librairie du Liban) 2006.

\(^{112}\) *Supra*, note 1, 63-64.

\(^{113}\) As explained in the footnotes of Qur’ān pertaining to verse Q5:90 ‘The arrows there referred to were used for the division of meat by a sort of lottery or raffle’.
The treatment of the prohibition of *gharar* in the Sunnah can be traced back to various Hadiths in the Sunnah. A representative set of Hadiths include:  

The Messenger of God forbade the 'sale of the pebble' [*hāṣāḥ, sale of an object chosen or determined by the throwing of a pebble*], and the sale of *gharar*.

Do not buy fish in the sea, for it is *gharar*.

Whoever buys foodstuffs, let him not sell them until he has possession of them.

He who purchases food shall not sell it until he weighs it [*yaktalahu*].

The Prophet forbade the sale of grapes until they became black, and the sale of grain until it is strong.

The above Hadiths provide examples of transactions where either chance or uncertainty govern the definition and/or delivery of the material aspects of the transaction. They also indicate that when this level of chance, or uncertainty, becomes more similar to gambling, than to acceptable level of business risk, the transaction is prohibited. Although there is *ijma*’ regarding this principle, there is *ikhtilāf* regarding the point on the spectrum between full information and certainty, and ignorance and speculation, at which the transaction traverses from a valid transaction of trade, to the prohibited exchange of *gharar*.  

4.1.3. *Freedom of Contract—To What Extent?*

This section will provide a discussion pertaining to the mandates found in the Sunnah that may serve to further constrain parties’ freedom of contract. Namely, traders are prevented from dealing in items that are prohibited; contracting in a manner that leads to that which is prohibited; or contracting based on actions that are specifically forbidden. Outside of the parameter of these prohibitions exists the frame of the parties’ freedom of contract.

It is in the concerns of the use of stipulations, or conditions, in contracts that there exists clear *ikhtilāf* amongst the *madāhib*. This divergence stems from the interpretations of the Hadiths. Namely, the following Hadiths

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114 Supra, note 1.

115 For more detailed discussion regarding the points on the spectrum which various schools define as the transition point, see supra, note 1, 88-93.

116 Supra, note 1, 67-68.
serve to restrict the parties’ use of stipulations117 and their use of one contract to accomplish multiple transactions:

[The Prophet] forbade a sale and a stipulation [bay’ wa sharṭ]

[The Prophet] forbade a sale and a loan [bay’ wa salaf]

The Messenger of God forbade two sales in one [bay’atayn fī bay’ā]

Primarily the four schools are to be found on the opposite ends of the spectrum regarding the permissibility of stipulations.118 Hanafi and Shafi’i are the most restrictive in their interpretation, permitting only stipulations that serve to facilitate the object of the contract or those found in customary law (‘urf) and rendering all others void. Whereas the Maliki and Hanbali schools have the widest, most permissive interpretation, with Ibn Taymia of the Hanbali school being the most permissive.

The Hanafi and Shafi’i schools119 are committed to the legal doctrine of singularity of the transaction in the contract, and allow only stipulations that are required to make the contract operative or those that are suitable to the purpose of contract or those that were customary in societal transactions. If a stipulation is not directly required by the contract, or is not customarily practised, and constitutes a benefit to one of the parties of the contract and not the other, it is considered a void stipulation and also results in the voiding of the contract. Also, the stipulations which benefit only one of the parties, such as if the seller of a house requires that he lives in it for a month, or the buyer of a piece of cloth requires the seller to make it into a dress, are void and result in the voiding of the sale. The reason is that the stipulations are seen to result in extra benefits, without a commensurate increase in the rate of the contract, and as such are considered riba, and the sale that includes riba is forbidden.

The other group, the Maliki and Hanbali schools,120 reject the doctrine of singularity of contract in most cases, and start from the principle of the validity of the stipulations. They consider the voidable stipulations are the

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117 ‘Stipulations are divided into three types: (1) conditions (ta’liq, literally “suspending”)—the conditioning of a contract on a future event; (2) extension (idafa)—delaying the beginning of the contract until a future time; and (3) concomitance (iqṭīrān)—varying the terms of the contract’. Vogel, citing Al-Sanhouri, see supra, note 1, 67-68, and 100.


119 Ibid., 168-171.

120 Ibid., 172-187.
exceptions. The only exceptions where singularity of the contract is required are the three cases specifically mentioned in the Hadiths identified above.

Ibn Taymiya,121 a Hanbali scholar, further relaxed the process of the validation of the stipulations by stating that contracts and stipulations are originally valid except in two cases: (1) Where there is a specific prohibition in the Shari’ah; or (2) If the stipulation contradicts the intent, or purpose, of the contract.

The consequences of entering into contracts that include riba, gharar, or that extend beyond the proscribed limitations on the parties’ freedom of contract, are considered void in Islamic law, and hence will not be enforced.

4.2. The Shari’ah and Public Policy

Islamic law, like every system of law, has a set of mandatory rules; these rules and their relation to public policy are the subject of this section.

Mandatory rules, which are meant to protect the interest of the community, cannot be contravened by private contract. Shari’ah requires conformity with these rules in no uncertain terms; private contracts involving acts that are contrary to the mandatory principles of Shari’ah are considered null and void. But, does violation of these mandatory rules result in a violation of what may be seen as ‘public policy’ within the eyes of Islam?

Answering this question requires a definition of public policy from within the context of Islamic law. A definition was provided by the Supreme Islamic court of Egypt that, together with other Islamic courts, was disbanded in the mid-1950s as follows:

Public policy [in Islamic law] does not permit that respect owed to religion be diminished by the violation of its rules and prescriptions formulated by a conclusive source which is acknowledged and admitted by the unanimity of spiritual leaders. [Decision of 23 September 1946]122

Sunni Muslim scholars have drawn the conclusion that any rule that originates from a religious source (Qur’ān, Sunnah, or ijma’) has conclusive and specific characteristics pertaining to public policy.123 From this, it may

121 Ibid., 187-191.
123 Ibid.
be concluded that a violation of the mandatory provisions of Shari’ah may be considered a violation of Islamic public policy.

**Table of Cases**