

## Pyrrhic Victory for Islamic Finance: The Further Growth of the Islamic Finance Industry

By Jawad I. Ali<sup>1</sup> and Omar Salah<sup>2</sup>

### Introduction

This White Paper discusses the current state of the Islamic finance industry. The authors argue that in an attempt to facilitate growth in the industry, the industry seems to have forgotten its identity. Reaching a juncture today, the authors advocate that the industry has to take a different direction and move towards more genuine Islamic financial products and transactions that are in line with the essence and spirit of Islamic finance, Islamic economics, and Islamic *Shari'ah*.

First, the current state of the Islamic finance industry is described. The authors emphasize that the industry has reached an important point from where we have to decide how to move forward. Certain commonly used instruments are highlighted to illustrate the current industry. The authors stress the importance of the essence and spirit of Islamic finance and give a description of it by placing it in the bigger picture of Islamic economics which finds its roots in Islamic *Shari'ah*. The importance of equity-based financing is emphasized.

This is followed by a description of current practice, which is dominated by debt-based financing and structures that are not always enforceable from a legal perspective. Based on the analysis of the backgrounds of Islamic finance and its current practice, the authors point out two aspects that need further attention.

First, the widespread use of debt-based instruments to finance projects and investments that may be more suitably financed through equity-based instruments is highlighted. Recommendations are made on how to deal with such financing and how to balance the use of equity-based and debt-based instruments. Second, the (im)balance between the *Shari'ah*-compliance of Islamic financial products and transactions and their legal enforceability is discussed. The authors recommend that the *Shari'ah*-compliance of financial products and transactions cannot be regarded separately from their legal enforceability. There must be a balance between the two and the authors cannot find such a balance in the financial products and transactions dominating the current market.

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<sup>1</sup> Jawad I. Ali, Managing Partner of Middle East Offices, King & Spalding; Global Deputy Head of Middle East & Islamic Finance Practice Group, King & Spalding.

<sup>2</sup> Omar Salah, Intern-Associate at Middle East & Islamic Finance Practice Group, London Office, King & Spalding; PhD Researcher Islamic Finance & Lecturer Corporate Finance at TISCO Research Institute of Private Law Department, Tilburg Law School, the Netherlands.

## 1. Current State of Islamic Finance Industry

The current state of the Islamic finance industry can be compared to the life span of a 40 year old man suffering from childhood phobias. The childhood fears of the man are a result of an experience as a ten year old child who tried to climb up a mountain, but got so exhausted that he decided to give up. However, he was determined to climb the same mountain once he would grow up. Therefore, he dedicated the rest of his life training. After 30 years of training the man was finally able to climb the mountain. However, restricted by childhood fears of the impossibility to climb the mountain, he seemed to continue his training extending his ultimate objective. By doing so he seemed to forget two important points: first, he is not the ten year old child anymore and, second, being a 40 year old man, he should not wait much longer.

This short anecdote illustrates the current state of the Islamic finance industry and its growth over the last 30 years. In order to realize the growth of the last 30 years, the industry has made several exceptions and compromises under the argument of 'the industry needs to be established first, before we can move towards a true Islamic financial system'. However, now that the industry has established itself as a market to be reckoned with<sup>3</sup>, this argument is not valid anymore. By posing such an argument, we seem to forget that our current industry is not the same as it was 30 years ago.

The last 30 years have proven that the problem of standardization is an issue that needs to be dealt with in the long term. Nevertheless, this does not mean that our current Islamic financial products should not be as genuine as possible and neither should it prevent us from making efforts to move towards a true Islamic financial system. Since the credit crunch, the industry has been experiencing an influx of conventional investors considering *Shari'ah*-compliant financing as an alternative. At this moment, we should make sure that Islamic finance offers a real alternative and that it is not merely another name for structures with the same economics as conventional structures. This is, moreover, important in order to give the industry its own identity as we have been trying to do for the last 30 years. We should not wait much longer, because otherwise we will have a completely established system that will be called Islamic finance, but will have the economics of conventional finance.

Therefore, we believe that it is important to understand the basics of Islamic economics and finance.<sup>4</sup> We have to identify what makes Islamic economics different from Capitalism and Marxism in order to decide upon the

<sup>3</sup> This is evidenced by the growth of the industry, its expansion towards non-Islamic countries, and its future prospects. Islamic banking assets rose by 28.6 % in 2009 to \$822 billion from \$639 billion in 2008, see The Banker & HSBC Amanah, *Top 500 Islamic Financial Institutions*, available at <http://top500islamic.thebanker.com/index.cfm?fuseaction=top500.home&CFID=1053940&CFTOKEN=10177553>.

Furthermore, Islamic finance is gaining ground in the Western world as well, as is evident from certain developments in Europe and the United States, see for example D. Oakley, *The Future of Islamic Finance, London leads in race to be western hub*, FINANCIAL TIMES, Dec. 8, 2009; *Islamic finance in France, Shari'ah calling*, THE ECONOMIST, Nov. 14, 2009. In addition, Moody's expects the long-term potential of the market to reach USD 5 trillion and the Global Head of Islamic Finance of Thomson Reuters expects the industry to reach USD 2 trillion within 5 years already, see S. Carhalvo & D. Holmes, *Islamic finance set to cross \$1 trillion-Moody's*, REUTERS, June 14, 2010; *Islamic finance set to be \$2 trillion industry globally within five years*, AMEINFO, May 25, 2010.

<sup>4</sup> For the purpose of this White Paper we assume a general knowledge of Islamic finance, its main principles and basic structures present with the reader. If the reader lacks such knowledge, we would like to recommend to gain that a knowledge by studying the established literature on Islamic finance, for example M.T. Usmani, *An Introduction to Islamic Finance* (Arab & Islamic Laws Series), The Hague: Kluwer 2001, M.A. El-Gamal, *Islamic Finance: Law, Economics, and Practice*, New York: Cambridge University Press 2006; M. Ayub, *Understanding Islamic Finance*, Chichester: John Wiley & Sons 2004. (Footnote continued on next page)

direction of our industry. The industry has reached a juncture at the moment and we would like to call upon the industry to re-consider the direction it is taking. We believe two aspects of the current market deserve our attention in particular. The first is the overreliance on debt-based instruments, which makes us move away from the essence of Islamic finance which we can find in equity-based financing. The second aspect is the imbalance between Islamic *Shari'ah* and the legal enforceability of certain Islamic financial products. These two points deserve our attention, because both points touch upon the identity of Islamic finance and the *Shari'ah*-compliance of the products.<sup>5</sup>

## 2. Background of Islamic Finance & Islamic Economics

In order to make changes, we need to move to the core principles of Islamic finance. This section discusses the historical background of Islamic finance and its main principles that can be found in Islamic economics. The position of Islamic economics within Islamic *Shari'ah* is discussed. This is followed by a description of Islamic economics as such and Islamic finance as a part of Islamic economics. The background knowledge acquired will provide comprehension of Islamic financial instruments.

### 2.1 Background of Islamic Economics

As a result of the Islamic revival of the late nineteenth century, Islamic economics emerged as a distinct branch of economics.<sup>6</sup> Sayyid Jamal al-Din al-Afghani was one of the most influential pioneers of Islamic modernism and anti-imperialism from the 1880s.<sup>7</sup> His pioneering efforts were viewed with much respect by the Islamic economists, since they saw themselves as modernisers in his mould.<sup>8</sup> In the early decades of the twentieth century, there were dispersed writings on economic topics throughout the Muslim world.<sup>9</sup> The first real influential writer was Sayyid Abu al-A'la Mawdudi, who established the term 'Islamic economics'.<sup>10</sup> Mohammed Baqir al-Sadr was another writer who added a significant contribution to Islamic economics with his book *Iqtisaduna*.<sup>11</sup>

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Sons Ltd. 2007; F.R. Vogel & S.L. Hayes, *Islamic Law and Finance: Religion, Risk and Return*, The Hague: Kluwer Law International 1998.

<sup>5</sup> We acknowledge that there are other aspects as well that our current industry is facing and that deserve the attention. However, in order to mark out the research for this White Paper, we had to make choices and focus on aspects which we in particular wanted to emphasize.

<sup>6</sup> R. Wilson, 'The Development of Islamic Economics: Theory and Practice', in: S. Taji-Farouki and B.M. Nafi (ed.), *Islamic Thought in the Twentieth Century*, London: I.B. Tauris 2004, at 195 (hereinafter: Wilson 2004).

<sup>7</sup> N.R. Keddie, 'Sayyid Jamal al-Din al-Afghani', in: Ali Rahnema (ed.), *Pioneers of the Islamic Revival*, London: Zed Books 1994, at 11-29.

<sup>8</sup> Wilson 2004, *supra* note 2, at 195.

<sup>9</sup> S.M.H. Rahman, *Islam ka iqtisadi nizam*, Delhi: Nadwat al-Musannifin 1942; S.M. Ahmad, *Economics of Islam: A Comparative Study*, Lahore: Sh. Muhammad Ashraf 1947.

<sup>10</sup> Many of the followers of Sayyid Abu al-A'la Mawdudi had a good knowledge of Western neo-classical economics through their undergraduate and postgraduate degrees and professional training, and were later to become significant contributors to the literature themselves. Amongst its most notable contributors this new generation included: M.A. Mannan, *Islamic Economics: Theory and Practice*, Lahore: Sh. Muhammad Ashraf 1970; M.U. Chapra, *Islam and the Economic Challenge*, (Footnote continued on next page)

In his book, Baqir al-Sadr demonstrated the incompatibility of both Marxism and Capitalism with Islam, a view supported by other writers as well.<sup>12</sup> He emphasized that, contrary to Marxism, for Muslims the ends of economic activities are spiritual.<sup>13</sup> Muhammad Nejatullah Siddiqi suggested that Marxism is in conflict with the basic requirements of the moral and spiritual growth of the human personality, which in the economic sphere requires private property and freedom of enterprise.<sup>14</sup> On the other hand, Mawdudi described Capitalism as extreme with excessive accent on the rights of individual ownership and freedom of enterprise that inflicted suffering and privation for those who owned less.<sup>15</sup> Siddiqi added to this that an unjustifiable focus on self-interest and the profit motive in Capitalism gave rise to a society lacking human character, brotherhood, sympathy and cooperation.<sup>16</sup> Syed Nawab Naqvi was critical of the neglect of human relations and especially the exploitation of labour in Capitalism.<sup>17</sup> Islam stresses a more generous attitude in regard to the ownership of wealth.<sup>18</sup> Therefore, most of the writers did not want to follow 'positivist economics' and regarded Islamic economics as a different doctrine.<sup>19</sup>

The distinguishing feature of Islamic economics, as also pointed out by Mufti Muhammad Shafi, is that it is a means to an end and not an end in itself.<sup>20</sup> The definition of Islamic economics begins with the assertion of the sources of Islamic *Shari'ah*: the Qur'an, the *Sunna*, *Ijma'*, and *Qiyas*. Various writers differ about the extent to which *Ijtihad* is allowed and which scholars can be regarded as the authoritative sources for understanding the

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Leicester: The Islamic Foundation 1992; S.N. Naqvi, *Islam, Economics and Society*, London: Kegan Paul International 1994; M.N. Siddiqi, *Muslim Economic Thinking*, Leicester: The Islamic Foundation 1981 (hereinafter: Siddiqi 1981).

<sup>11</sup> M.B. Al-Sadr, *Iqtisaduna*, Beirut: Dar al-Fikr 1961; K.J. Shubber, *Our Economics: Iqtisaduna*, London: Bookextra 2000; A. Rieck, *Unsere Wirtschaft: Eine Gekürzte Kommentierte Übersetzung des Buches Iqtisaduna von Muhammad Baqir al-Sadr*, Berlin: Klaus Schwarz 1984.

<sup>12</sup> R. Wilson, 'The Contribution of Muhammad Baqir al-Sadr to Contemporary Islamic Economic Thought', *Journal of Islamic Studies* 1998-9, at 46-59.

<sup>13</sup> Baqir al-Sadr stressed the different views of Islamic economics and Marxism. According to him, material consumption and having power over resources are regarded as the ends for Marxists; these factors are only means for Muslims and the ends are spiritual. He, furthermore, rejected the class categorisation of Marxism as simplistic, because capitalists and workers are, besides being products of a system of production, also - maybe, even more - human beings with moral responsibilities, see Wilson 2004, *supra* note 2, at 202.

<sup>14</sup> Siddiqi 1981, *supra* note 6, at 52-3.

<sup>15</sup> S.A.A. Mawdudi, *Islam aur jadid m'ashi nazariyat*, Lahore: Islamic Publishers 1966, at 52-83.

<sup>16</sup> Siddiqi 1981, *supra* note 6, at 46.

<sup>17</sup> *Id.*, at 205.

<sup>18</sup> Wilson 2004, *supra* note 2, at 205.

<sup>19</sup> A.Al-H.M. Al-Ba'li, *Maqasid al-Shari'ah wa-mushkilat al-hajjat fi al-iqtisad*, Cyprus: International Institute for Islamic Banks and Economy 1987, at 31-3; M.M. Nur, *Al-Iqtisad al-Islami*, Cairo: Maktabat al-Tijarah wa Ta'awun 1978, at 18-20 (hereinafter: Nur 1978); Y. Kamal, *Adwa' ala-fikr al-iqtisadi al-Islami al-mu'asir*, Cairo: Majallat al-Da'wah 1980, at 17-8; M.S. Al-Fanjari, *Dhahiyat al-siyasiyat al-iqtisadiyat al-Islamiyah*, Cairo 1981, at 18-20; M.S. Al-Fanjari, *Al-Madhab al-iqtisadi fi al-Islam*, Cairo: al-Hai'at al-Misriyat al-'Ammah li-l-Kitab 1986, at 91-3; M.M. 'Uthman, *Nazriyat al-infitah al-iqtisadi fi al-Islam*, Cairo: al-Dar al-Misriyah li-l-Tab'ah wa-l-Nashr 1990, at 33-4.

<sup>20</sup> Mufti M. Shafi, *Distribution of Wealth in Islam*, Karachi: Ashraf Publications 1978 (translated into English by M.H. Askari & K. Husain).

rules of Islamic economics.<sup>21</sup> Consequently, there has been contrasting approaches among Muslim intellectuals helping to define this field.<sup>22</sup> Some of these intellectuals focused on what the sources of Islamic *Shari'ah* have to say about *riba*, *zakat*, the status of property, accounting, and the market.<sup>23</sup> Others tried to develop an explicit set of Islamic values for economic activity endeavouring to ensure that their interpretations remain true to the principles contained in the sources of Islamic *Shari'ah*, while trying to engage successfully with the economic sphere as presently constituted at the same time.<sup>24</sup> Islamic finance has been part of the latter movement. It must be emphasized that this movement strived to ensure to remain true to the principles of Islamic *Shari'ah*.

## 2.2 Background of Islamic Finance

From the 1950s, publications on interest-free banking started to appear and a notable early contributor was the scholar Muhammad Uzair.<sup>25</sup> The key concept of Islamic finance is that lenders must participate in the risk of the business, in order to earn a reward.<sup>26</sup> The Islamic economic model emphasises fairness<sup>27</sup> Islamic banking has the same purpose as conventional banking, except that it operates in accordance with *Fiqh al-Mu'amalat*, which contains the Islamic rules on transaction.<sup>28</sup>

These rules are meant to achieve the higher purpose of Islamic economics, according to which the economic activities are means to an end, the end being achieving (economic) fairness in society. Rules such as the prohibition on *riba* and *gharar* are meant to achieve fairness through equitable distribution of the wealth in society. As Mufti Muhammad Taqi Usmani points out, the noble objective of the prohibition of *riba* is equitable distribution among partners of revenues from commercial and industrial enterprises.<sup>29</sup> Therefore, Islamic finance prefers profit-and-loss-sharing (PLS) arrangements as a way of financing.<sup>30</sup> Mufti Usmani mentions that the real

<sup>21</sup> Nur 1978, *supra* note 15, at 53-5.

<sup>22</sup> C. Tripp, *Islam and the Moral Economy: The Challenge of Capitalism*, Cambridge: Cambridge University Press 2006, at 111-112 (hereinafter: Tripp 2006).

<sup>23</sup> T. Philip, 'The idea of Islamic economics', *Die Welt des Islams* 1990-30, at 124-8; F. Nomani & A. Rahnema, *Islamic Economic System*, London: Zed Books 1994, at 45-8. For 'traditional' approaches to the identification of Islamic economics see M.H.A. Yahia, *Iqtisaduna fi daw' al-Qur'an wa-l-sunnah*, Amman: Dar Amman lil-Nashr 1988; A.Al-S.D. Al-'Abbadi, *Al-Milkiyah fi al-Shari'ah al-Islamiyah*, Amman: Maktabat al-Aqsa 1977; R.Y. Al-Masri, *Usul al-iqtisad al-Islami*, Damascus: Dar al-Qalam 1989; M.K.Al-D. Imam, *Usul al-hisbah fi al-Islam*, Cairo: Dar al-Hidayah 1986; Y. Al-Qardawi, *Dawr al-qiyam wa-l-akhlaq fi al-iqtisad al-Islam*, Cairo: Maktabah Wahbah 1995.

<sup>24</sup> Tripp 2006, *supra* note 18, at 111-112.

<sup>25</sup> M. Uzair, *An Outline of Interestless Banking*, Karachi: Raihan Publications 1955.

<sup>26</sup> A. Zaman, *Islamic Economics: A Survey of the Literature* (Working Paper 22 – 2008 of the Religious and Development Research Programme), Birmingham: Department for International Development 2008, at 41 (hereinafter: Zaman 2008).

<sup>27</sup> M. Ainley *et al.*, *Islamic Finance in the UK: Regulation and Challenges*, London: Financial Services Authority 2007, at 4.

<sup>28</sup> S.Q. Qadri, 'Islamic Banking, An Introduction', *Business Law Today* 2008-6, at 59.

<sup>29</sup> Mufti M.T. Usmani, *Sukuk and their Contemporary Applications*, AAOIFI *Shari'ah* Council: 2008 (translated into English by: Y.T. DeLoranzo), at 13.

<sup>30</sup> M.O. Farooq, 'Partnerships, Equity-Financing and Islamic Finance: Whither Profit-Loss Sharing?', *Review of Islamic Economics*, Vol. 11, Special Issue, 2007, at 67-88.

and ideal instruments of financing in Islamic *Shari'ah* are the PLS arrangements, such as *musharaka* and *mudarabah* agreements.<sup>31</sup> These forms of equity-based financing are in line with the Islamic view on financial transactions that one cannot be entitled to a reward if one has not taken any risk. However, Islamic finance also acknowledges debt-based instruments such as *murabaha*. These instruments were not originally modes of financing, but were reshaped in order to meet certain needs.<sup>32</sup>

### 3. The Role of Debt-Based Financing in the Current Market

Before discussing the role of debt-based financing in the current market, it is important to address its position within Islamic finance as such. The dominating, and almost destructive, impact of *murabaha* contracts in particular will be pointed out, after which recommendations are made to bring a balance in current practice.

#### 3.1 Debt-Based Financing within Islamic Finance

The previous paragraph stressed the preference for equity-based financing as an ideal way of *Shari'ah*-compliant finance. Debt-based finance is allowed under Islamic *Shari'ah*, but often as an exception to the rule. For example, the *murabaha* contract is in essence a contract of sale. A *murabaha* contract denotes a sale contract, whereby the seller adds a profit to the cost price of a commodity and discloses the cost price to the buyer.<sup>33</sup> Initially it was not a mode of financing, neither meant to be used as a mode of financing; the ideal mode of financing according to Islamic *Shari'ah* is *musharaka* and *mudarabah* agreements.<sup>34</sup> As Mufti Usmani mentions, *murabaha* as a mode of financing was merely allowed by *Shari'ah* scholars due to practical difficulties in the current economic set up in using the equity-based financial contracts.<sup>35</sup> This clearly illustrates these debt-based financial contracts such as the *murabaha* agreements were allowed as an exception to the rule.

Furthermore, it is important to understand that besides being allowed as an exception, the *murabaha* agreement has been subject to certain conditions, one of these conditions being that it may only be used as a mode of financing where the client requires funds to actually purchase commodities.<sup>36</sup> This illustrates the possibility to use *murabaha* for working capital, e.g. to finance the purchase of raw materials required for the company of the client.<sup>37</sup> As an exception to this condition, we have witnessed the contract of *tawarruq*, often referred to as the commodity-*murabaha*,<sup>38</sup> in recent years as a tool to provide liquidity.<sup>39</sup> It must be noted that we are talking about

<sup>31</sup> Mufti M.T. Usmani, *An Introduction to Islamic Finance*, The Hague: Kluwer Law International 2002, at x (hereinafter Usmani 2002).

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*, at 37-41.

<sup>34</sup> *Id.*, at 41.

<sup>35</sup> *Id.*, at 41-4.

<sup>36</sup> *Id.*

<sup>37</sup> F.R. Vogel & S.L. Hayes, *Islamic Law and Finance: Religion, Risk and Return*, The Hague: Kluwer Law International 1998, at 182 (hereinafter: Vogel & Hayes 1998).

<sup>38</sup> The industry is using the term *tawarruq* and commodity *murabaha* interchangeably. However, from a doctrinal perspective this is not entirely correct. In the strict sense, *tawarruq* is the purchase of an asset on deferred payments and the sale of those assets to another party on the spot in order to get cash, as defined in a *fatwa* of the International *Fiqh* (Footnote continued on next page)

an exception to an exception at this point, since a *tawarruq* unlike a *murabaha* is not used where a client is in need of funds to actually purchase the particular commodity. Rather, the *tawarruq* is used where the client is in need of cash to finance other activities.

### 3.2 Debt-Based Financing within the Current Market

In the current Islamic finance market, debt-based instruments are more widely used than equity-based instruments. This assertion is supported by Standard & Poor's who has indicated in a recent report that *murabaha* together with *ijara* dominates the current market.<sup>40</sup> It is generally assumed that *murabaha* agreements cover 80 per cent of all Islamic financial transactions.<sup>41</sup> The use of *murabaha* contracts and *tawarruq* contracts for working capital or as a tool for liquidity is acceptable, as long as the strict conditions of Islamic *Shari'ah* are met. Especially when there are no other real alternatives, the use of *murabaha* and *tawarruq* in asset finance, or for working capital purposes, or as a tool for liquidity becomes necessary.

However, the current widespread use and abuse of these instruments within Islamic finance is something we do not support. For example, in certain jurisdictions it has become a common practice to finance real estate developments or acquisitions through metal *murabaha* or *tawarruq* contracts. Instead of using the contracts that are specifically designed for these purposes within Islamic finance, contracts such as *istisna'* for the construction of projects and *musharaka* and *mudarabah* for certain project financing whereby these alternatives are available and suitable, the industry is moving towards the use of metal *murabaha* or *tawarruq* contracts to finance such projects. This practice is not sustainable and will ultimately hinder the growth of the Islamic finance industry. We have to use metal *murabaha* or *tawarruq* sparingly and in exceptional circumstances where there are no alternatives and only for the purposes these instruments were meant for. It seems, however, that the exception has become the norm in our current industry.

Currently, we are building a complete industry on exceptions. If we start using these contracts for financing where alternatives are available, then the industry will not create its own identity neither will we witness genuine Islamic financial products for which we have been striving in the last 30 years. The *Shari'ah* scholars have a strong

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Academy for Muslim World League in 1998, see The International *Fiqh* Academy for Muslim World League, *Fatwa on Tawarruq*, 15<sup>th</sup> Session in Makkah, 11-15 Rajab, 1419 H.A., available at <http://www.isra.my/>. Although the transaction preceding the *tawarruq* often makes that a *tawarruq* is a *murabaha* at the same time, this does not necessarily have to be the case. Therefore, these terms are often used interchangeably and mostly *tawarruq* is included or referred to as well, when *murabaha* contracts are discussed. In order to stay consistent with the doctrine of Islamic finance, we will refer to *tawarruq* when *tawarruq* is meant and to *murabaha* when *murabaha* is indicated.

<sup>39</sup> S. Cox & A. Thomas, 'Liquidity management: developing the Islamic capital market and creating liquidity', in: A. Thomas, S. Cox & B. Kraty (eds.), *Structuring Islamic Finance Transactions*, London: Euromoney Books 2005, at 174.

<sup>40</sup> Standard & Poor's, *Islamic Finance Outlook 2008*, at 11; Standard & Poor's, *Islamic Finance Outlook 2010*, at 18.

<sup>41</sup> R.W. Hefner, 'Ambivalent Embrace: Islamic Economics and Global Capitalism', in: J.B. Imber (ed.), *Market, Morals & Religion*, New Jersey: Transaction Publishers 2009, at 148; E. Stiansen, 'Al-Islam Huwa Al-Hal: The Qur'an and Contemporary Islamic Finance', in: N. Kastfelt (ed.), *Scriptural Politics: The Bible and the Koran as Political Models in the Middle East and Africa*, London: C. Hurst & Co. Publishers 2003, at 83; K. Bälz, 'Islamic Law as the Governing Law under the Rome Convention: Universalist *Lex Mercatoria* v. the Regional Unification of Law', in: M Cotran & M. Lau (eds.), *Yearbook of Islamic and Middle Eastern Law* (Volume 8, 2001-2002), The Hague: Kluwer Law International 2003, at 78; Vogel & Hayes 1998, *supra* note 33, at 135.

responsibility here: the use of metal *murabaha* and *tawarruq* agreements for purposes it is not meant for should be approved as *Shari'ah*-compliant in only exceptional cases. Indeed, the whole industry - including investors, lawyers, investment bankers, and all others involved in the process - bear responsibility, but the truth of the matter is that so long these contracts are readily and easily available and approved as a *Shari'ah*-compliant alternative, the industry will not take the effort to move towards other contracts such as *musharaka*, *mudarabah*, *istisna'*, and *ijara* contracts.

#### 4 The Balance between *Shari'ah*-Compliance and Legal Enforceability

##### 4.1 Imbalance between *Shari'ah*-Compliance and Legal Enforceability: Transfer of Ownership

As mentioned above, within Islamic economics, economic activities are a means to an end. By meeting certain *Shari'ah* requirements, we should not forget that we should eventually stay true to the principles and objectives of Islamic *Shari'ah*. A point where we see such a mismatch relates to the balance between the *Shari'ah*-compliance of the products and legal enforceability. The industry has witnessed several products over the last years that exhibited an imbalance between *Shari'ah*-compliance and their legal enforceability. We submit that a *Shari'ah*-compliant instrument and/or structure should always take into consideration the rules and regulations of the particular jurisdiction and that the architects of such instruments and/or structures should make sure that such instruments and/or structures are enforceable under the law of such jurisdiction.

This can be illustrated by the concept of ownership in Islamic financial transactions.<sup>42</sup> From a *Shari'ah* perspective ownership can be transferred by a contract that is valid under Islamic *Shari'ah*.<sup>43</sup> Within Islamic *Shari'ah*, no explicit reference is made to registration formalities. Therefore, most *Shari'ah* scholars regard the transfer of ownership of an immovable asset without fulfilling any registration formalities as valid under Islamic *Shari'ah*. However, from a legal perspective in certain jurisdictions the *Shari'ah* owner does not become the legal owner if no registration formalities are fulfilled. As a consequence, the owner cannot enforce his rights as an owner in a court of law according to the law of the particular jurisdiction. Moreover, a significant part of the transactions today are structured in jurisdictions outside the Muslim world where the Islamic *Shari'ah* is not part of its legal system. What is the meaning of being the *Shari'ah* owner of an asset, if one cannot enforce its rights as the legal owner according to the law of a particular jurisdiction? We witnessed such imbalances between the *Shari'ah*-compliance of a structure and its legal tenability at the end of 2009, when the Nakheel *Sukuk* went into default.<sup>44</sup> One of the aspects that were raised was the uncertainty on the position of the *sukuk* holders due to a lack of formal registration systems in regard to leasehold rights and rights of mortgages during the issue of the *sukuk* in the United Arab Emirates.<sup>45</sup>

<sup>42</sup> We would like to point out that the transfer of ownership is merely an example to make our point. The problem of an imbalance between *Shari'ah*-compliance and legal enforceability, furthermore, relates to, *inter alia*, the enforceability of *wa'ad* and the use of agency agreements in jurisdictions that do not recognize the concept of a trust.

<sup>43</sup> Vogel & Hayes 1998, *supra* note 33, at 102-5.

<sup>44</sup> For more on the legal aspects of the Nakheel *Sukuk*, see O. Salah, 'Dubai Debt Crisis: A Legal Analysis of the Nakheel *Sukuk*', *Berkeley Journal of International Law, Publicist* 2010, Volume 4, at 19-32.

<sup>45</sup> We acknowledge that the Nakheel *Sukuk* also had other legal issues that contributed to the uncertainty around the default, such as, *inter alia*, the (im)possibilities regarding the enforcement of foreign judgements in the United Arab Emirates and uncertainty on the role of the government.

#### 4.2 Importance of *Shari'ah* Background

Within the Islamic *Shari'ah*, we can also find arguments to support this view. First of all, the importance of the *niyya* within Islamic *Shari'ah* should not be underestimated. As Zaman points out by referring to a *hadith* of *Sahih Muslim*, an incorrect *niyya* can even invalidate the noble act of giving charity.<sup>46</sup> If our true intention - our *niyya* - is to transfer the ownership of an asset to another party, we should make sure that the new owner really becomes the owner from both an Islamic *Shari'ah* and legal perspective and that he can enforce his right as an owner and enjoy the protection he needs as an owner. Second, the Quran dictates that it is preferable to write down contractual obligations.<sup>47</sup> Writing down contractual commitments gives the parties involved certainty on what is agreed upon in case of disputes. This has the same function as the registration formalities: fulfilling these formalities by writing it down in public registers gives certainty in case disputes arise involving third parties. This illustrates that the essence of Islamic *Shari'ah* is often in line with the background of certain legal requirements. Therefore, we should consider the objectives of Islamic *Shari'ah* when structuring our transactions.

We advocate that one cannot be the owner of an asset from a *Shari'ah* perspective if the person cannot legally enforce its ownership interest. As a consequence, it is not enough that a structure is declared *Shari'ah*-compliant; it must also be legally enforceable. The *Shari'ah*-compliance and legal enforceability of a transaction should be inter-connected otherwise the meaning and importance of the *Shari'ah* ruling within a transaction will be undermined. Furthermore, it will lead to results whereby the specific requirements are met from a *Shari'ah* perspective, while the objectives of Islamic *Shari'ah* are not met.

#### Summary of Recommendations

Based on the above we would like to make the following recommendations. First, we would like to emphasize the importance of industry experts coming together to discuss these issues. *Shari'ah* scholars, academics, investment bankers, lawyers, accountants, and all others involved in the process must gather to address these issues and search for a solution together. Therefore, initiatives such as that of Hawkamah and the American Bar Association are not merely appreciated, but are also required in order for the industry to improve.

In regard to the specific points discussed in this White Paper, we would like to make the following recommendations:

- The importance of equity-based financing must be acknowledged by the industry in practice, i.e. we should move towards the use of *musharaka* and *mudarabah* contracts;
- The overreliance on debt-based financing should not continue;
- *Murabaha* agreements should only be used for the purposes they are meant to be used for, such as, *inter alia*, the acquisition of an asset.
- *Tawarruq* agreements, or commodity *murabaha*'s, should not be used for financing where Islamic finance has real alternatives. It must be limited to the necessary purposes, such as, *inter alia*, overnight liquidity and working capital.

<sup>46</sup> Zaman 1008, *supra* note 22, at 34-44.

<sup>47</sup> Quran 2:282.

- Where Islamic finance offers a real alternative for real projects in the form of *musharaka*, *mudarabah*, *istisna'*, and *ijara* these alternative must be applied rather than *murabaha* and *tawarruq* agreements;
- Investors should accept that when choosing to invest or finance on a *Shari'ah*-compliant basis they will have to take certain risks associated with the investment they are making or financing;
- Investment bankers and lawyers must acknowledge the essence of Islamic finance and should stop trying to mimic conventional products;
- *Shari'ah* scholars should consider not approving the use of *murabaha* and *tawarruq* when other forms of Islamic financing are available; and
- There must be a balance between the *Shari'ah*-compliance of Islamic financial transactions and products and their legal enforceability: it is not sufficient that a transaction or product is *Shari'ah*-compliant, it must also be legally enforceable.

## Conclusion

Considering the background of Islamic economics and Islamic finance, we are of the opinion that our current industry has not yet met the objectives of Islamic finance. Although Islamic economics requires an economic system, where risks and rewards are shared between the parties involved which is best realized with equity-based financing, practice over the last years has over relied on debt-based instruments. As a consequence, debt-based instruments have been used to finance projects and investments where there are other more suitable alternatives. Furthermore, the imbalance between *Shari'ah*-compliance and the legal enforceability of Islamic financial transactions and products has resulted in transactions and products that do not provide the protection investors are seeking since the structures used to implement such transactions and products were not compliant with the requirements of the law of the particular jurisdiction. As a result, the industry has witnessed transactions that technically met the formal requirements of Islamic *Shari'ah*, but did not accomplish its objectives. This is not in line with the spirit of Islamic economics, nor with the essence of Islamic *Shari'ah*.

Since the industry is still developing itself, this is not so much a point of criticism, but rather a moment of consciousness. We should take the challenge the industry is facing and move towards improvements. If we continue merely focusing on the growth of the industry, which is almost a more Capitalistic approach than an Islamic economical approach, we might realize the further growth of the Islamic finance industry at the cost of losing the identity and principles upon which the industry was started. We wonder whether that is a price worth paying. Eventually, such a victory will merely be a Pyrrhic victory.<sup>48</sup>

<sup>48</sup> A Pyrrhic victory, named after King Pyrrhic of Epirus, indicates a victory with devastating cost to the victor. King Pyrrhic's armies suffered irreplaceable casualties while defeating the Romans around 300 BC during the Pyrrhic War. A Pyrrhic victory refers to a victory that ultimately is a defeat for the victor, although on the outlook it looks like a victory.

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