

A CRITICAL ANALYSIS OF THE COMPLIANCE OF ISLAMIC FINANCE PRODUCTS WITH SHARIAH LAW

ABSTRACT

Islamic Finance (IF) has enjoyed a meteoric rise in recent times outgrowing conventional in most of the world's predominantly Islamic countries of the world with an estimated worth of \$920 billion and a projected growth in worth to approximately \$ 1.6 trillion by 2020 according to Ernst & Young.¹ In the United Kingdom, the FSA has put the growth of Islamic Finance Islamic in recent years at 10% – 15% per annum Finance in the United Kingdom with an estimated worth of £250 Billion.²

The rise in popularity of Islamic Banking has led many scholars and clerics to question the compatibility of the products offered by IF banks with Shariah Law. One major argument put forward put the critics of Islamic Finance is that the product engineering process only seeks to circumvent the prohibitions of shariah law and nothing more. The opposing view of other clerics is that it is the engineering process that makes IF products sharia compliant, just like the mode of slaughtering makes meat *halal* or *haram*.

This paper primarily seeks to analyse IF products critique them, examine their compliance with sharia law and whether they are merely engineered to circumvent the prohibitions of *Riba* (Usury) and *Gharar* (excessive risk) under Sharia Law. Most of the paper will be dedicated to examining the Murabaha which is the most popular of the Islamic Products used by Islamic Finance Institutions and not surprisingly, the most controversial IF product and exposing its similarity with conventional banking products both in form and substance.

1.0 INTRODUCTION

Islamic Finance (IF) is finance based on Islamic principles as enshrined in glorious Qur'an and Prophetic actions (Sunnah).³ One major feature of Islamic finance which distinguishes it from conventional finance is its compliance with sharia law,⁴ the law which defines the lifestyle of every Muslim.

According to Sharia law, a valid IF transaction must not contain elements such as *riba*, *gharar*, *qimar* (gambling), and *maysur* (games of chance involving deception).⁵ The major guiding principles of IF are the prohibition of *Riba* (usury) and *Gharar* (excessive risk).⁶ It can be said that the very essence of Islamic Finance is to provide financial services which do not violate the injunctions of Islam as determined or interpreted by scholars from whom a religious ruling or fatwa has been sought.⁷ These factors make El Gamal describe IF as 'a prohibition-driven industry'.⁸

¹ Ernst & Young, 'EY: Islamic Banking Growth on the Increase Across Globe' <<https://www.consultancy.uk/news/3102/ey-islamic-banking-growth-on-the-increase-across-globe>> accessed 9th May 2019.

² Bank of England and Financial Services Authority Briefing Note (2006).

³ Oliver Agha, 'Islamic Finance: Principle before Profit' (2009) 2 (1) Berkely J Middle E & Islamic L 125 -127; See Also; Sulman A. Bhatti, 'The Shari'ah Compliance and the Challenge and Opportunity of Embracing Finance Without Interest' (2010) Colum. Bus. L. Rev. 205, 208.

⁴ Mahmoud A. El-Gamal *Islamic Finance Law, Economics and Practice* (Cambridge: 2009) 7.

⁵ Omar Masood, *Islamic Banking and Finance Definitive Texts and cases* (Palgrave Macmillian: 2011) 10.

⁶ Usman Hayat, Adeel Malik *Islamic Finance: ethics, Concepts, Practice* (CFA Institute Research Foundation 2014) 26.

⁷ Hayat, Malik (n 6).

⁸ El-Gamal (n 4) 8.

Islamic finance has been widely upheld as an alternative to conventional finance over the years.⁹ Islamic banking and finance has witnessed immense growth due to the failures of conventional banking and the need to satisfy devout Muslims.¹⁰ However, its present-day practice has been controversial. ‘The controversy seems to border on two issues: (i) The compliance of products with Sharia and (ii) whether it’s of any economic value’.¹¹ This paper examines the prohibitions, the products and whether the contemporary Murabaha product is sharia-compliant or not.

2.0 THE MAJOR PROHIBITIONS IN ISLAMIC FINANCE

The major IF prohibitions are Riba (usury) and Gharar (excessive risk) whose prohibition flows from the Qur’an and the practices of the Prophet Mohammad¹². The reason behind these prohibitions is the promotion of social welfare and not just for the structuring of Islamic Finance.¹³

2.1 Riba is one of the major pillars of Islamic Finance. ‘It literally means an increase, growth or accretion’.¹⁴ ‘In Islam, generating an unjustified profit from lending money is prohibited’.¹⁵ In other words, it is a prohibition on the charging of interest in IF transactions.¹⁶ The literature available suggests that there are two types of Riba.¹⁷ One prohibited by both the Qur’an and the prophet’s tradition and involves a time delay before the money is returned and the other prohibited by the traditions of the Prophet only and does not involve any such delay’.¹⁸ Riba is often the bone of contention between Islamic scholars on whether a product is sharia complaint or not. ‘Some scholars have opined that the use of interest is unjustifiable in Islam while others are of the opinion that it is a reward for savings- productivity of capital – and constitutes the difference between the value of goods today and their value tomorrow’.¹⁹ ‘In their defence of interest, they argue that it could be justifiable if it resulted in reinvestment and the resultant growth in capital and not just a reward for forgoing consumption’.²⁰ Harasani opines that there are two types of Riba, *ribd I-'uqid* (usury in Contracts) and *riba I-quria* (usury in loans) and that the rationale behind the latter is solely to create Islamic compliant financial Schemes.²¹ It must be made clear that Riba does not prohibit the lending of money, rather, it prohibits the unjustifiable profits made from lending such money as these profits are against Islamic tenets.

⁹ Sheharyar Sikander Hamid, ‘Re-Reading of the Fundamentals of Islamic Finance: Principles of Contract Law, Riba and Gharrar in light of the Masaqasid al Sharia and Maslaha Principle’ (2015) 11: 2 J Islamic St Prac Int’l L 37.

¹⁰ David A. Suratgar, ‘The Impact of Islamic Banking on World Financial and Commercial Relations’ (1984) 16 (4) Law & Pol’y Int’l Bus. 1089.

¹¹ Hayat, Malik (n 6) 5.

¹² Reyadh Mohammed ‘Legal Aspect of Islamic Finance’ (2015) 29 (3) Arab LQ 285, 288-289.

¹³ Hayat, Malik (n 6) 31.

¹⁴ Hourani, Husmani ‘The Three Principles of Islamic Finance explained’ (2004) 23 Int’l Fin. L. Rev. 46.

¹⁵ Hamid (n 9) See Also; Nico P. Swartz and Odrile Otta Itumeleng and Wankie and Anisha Jeelabdeen and R Kumar, ‘The Riba Conundrum: the Ethical Appeal of Islamic of Islamic Banking’ (2013) 3 (4) J Mgmt & Sustainability 184,189-190; Dusica Boskovic and Sanja Mandic and Sonja Andjelkovic, ‘Basic Concepts in Islamic Banking’ (2015) 5 Intl J Econ & L 35, 39 -42.

¹⁶ Imitiaz A. Pervez, ‘Islamic Finance’ (1990) 5 (4) Arab L.Q. 259, 262-263.

¹⁷ Hayat, Malik (n.6) 26.

¹⁸ Husmani (n 14).

¹⁹ Omar Masood, (n 5) 11.

²⁰ Pervez (n 16).

²¹ Hamid Harasani, ‘Analysing the Islamic Prohibition on Riba: A Prohibition on Substance or Form’, (2013) 27 Arab L.Q. 291.

Gharar, means ‘uncertainty’ or ‘excessive and avoidable uncertainty’, the underlying principle behind the prohibition of *Gharar* is that trading in risk is unacceptable in sharia law.²² As such any contract, which has elements of excessive risk or speculation is *void ab initio* under shariah law, for example, if Mr A. contracts to sell MR.B a house he will likely inherit when his father passes away, such a contract is void under sharia and such a transaction cannot be a subject of Islamic Finance²³. This prohibition is only applicable to transactions which involve an exchange of goods or assets but do not apply to gifts or donations.²⁴ Furthermore, for *gharar* to disqualify a contract it must be ‘(i) excessive (ii) It must be a commutative financial contract (iii) the uncertainty must affect the principal components of the contract (iv) no need is met by the contract containing *gharah* that cannot be met otherwise’.²⁵ Therefore, a contract where parties are oblivious of the subject matter (or its existence), the time of performance and their respective obligations under the contract is void under sharia.²⁶

3.0 **Overview of Islamic Finance Products and Instruments**

Like conventional Finance, Islamic Finance also offers an array of products which are Shariah-compliant but we shall briefly consider two in this paper. They are;

3.1 **Murabaha**

This is the most commonly used methods of financing used by Islamic Banks.²⁷ It is ‘a cost-plus-sale contract where an Islamic Bank purchases a product for a client and re-sells it to him at an agreed mark-up price that is paid in instalments’.²⁸ This is as an alternative to lending money for credit used by Islamic Banks, instead, the bank (or Financier) buys a good and sells it unto the lender (Customer) with a disclosed profit.²⁹ This makes the transaction between Banker and Customer Shariah compliant. Masood posits that to qualify as a valid sale under shariah law, it is a requirement that a *Murabahah* contract must be the result of an original sale and not a means of financing an existing inventory.³⁰

3.2 **Mudaraba**

This is one of the main instruments of participatory Finance in Islam Banking.³¹ Mudaraba is a shariah compliant equity financing instrument.³² Its applicability to contemporary banking

²² Mahmoud A. El-Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance* (Rice University 2000) 6 < <http://www.ruf.rice.edu/~elgamal/files/primer.pdf>>

²³ ; Sulman A. Bhatti, ‘The Shari’ah Compliance and the Challenge and Opportunity of Embracing Finance Without Interest’ (2010) *Colum. Bus. L. Rev.* 205, 219.

²⁴ Hayat, Malik (n 6) 28.

²⁵ Siddiq M.A Al-Dhareer, ‘Al-Gharar in contracts and its effects on contemporary transactions’ (1997) *Eminent Scholars’ Lecture Series* No.16, 44.

²⁶ Dusica Boskovic and Sanja Mandic and Sonja Andjelkovic, (2015) 5 *Intl J Econ & L* 35, 37-38.

²⁷ Omar Masood, (n 5) 17 See Also: Mahmoud A. El-Gamal (n 5) 67; Usman Hayat, Adeel Malik (n.6) 32; S. B Sairally, ‘Murabaha Financing: Some controversial issues’ (2002) *Review of Islamic Economics*, 73; Umar Oseni ‘Towards restructuring the legal framework for payment system in international Islamic trade finance’ (2013) *JITLP* 12(2), 114.

²⁸ Necmeddin Guney ‘Murabahah Financing Revisited: Contemporary debate on its use in Islamic Banks’ (2015) *Intellectual Discourse* 23: Special Issue 496:

<https://journals.iium.edu.my/intdiscourse/index.php/islam/article/view/698> accessed on 3rd May 2019. See also Barbara L. Seniawski, ‘Riba Today; Social Equity, the Economy, and doing Business under Islamic Law’ (2001) 701, 723.

²⁹ Usman Hayat, Adeel Malik (n 6) 33.

³⁰ Omar Masood, (n 5) 17.

³¹ Rodney Wilson ‘The issue of interest and the Islamic financing alternatives’ (1997) *J.I.B.L* 26.

³² Hjh Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’ (2009) *Comp. Law* 176.

was first pointed out by Hjh Siti Faridah Abd Jabbar who argued that ‘where depositors deposit money with a bank and the bank then advances the money to a client, the principles of *mudaraba* may be employed with the depositors sharing in the bank's profits and the bank sharing in the profits of the client's venture’.³³ ‘*Mudaaraba* is simply an arrangement where an Islamic Bank or Institution (rab al maal) invests directly in an existing business and shares in the profits with the owner (mudarib)’.³⁴ Thus, instead of lending money in return for interest the bank elects to partner with the borrower in his business venture and assumes some of the business risks and by so doing complies with the prohibitions against *riba* and *gharar*, for this reason, *mudaraba* is regarded as a purely Islamic Finance product.³⁵ This trust-based financing may be short, medium or long term.³⁶

3.3 Is Murabaha A Sharia-Compliant Product?

The growth of Islamic Finance in recent years has put it on the spotlight and it has been critiqued for being sharia-compliant only in form and not in substance. The *Murabaha* has been the subject of immense debate mainly because scholars find the arrangement artificial since banks act as pure financial intermediaries and not traders.³⁷ Furthermore, most scholars view the *Murabaha* as a contract designed primarily to circumvent the prohibitions of *riba* and *gharar*, an act known as sharia arbitrage’.³⁸

Presently, over 70% of Islamic finance is based on *Murabaha* and this has led to its legitimacy as a sharia -compliant product being disputed.³⁹ Most of the points raised against its legitimacy can be summarised as: ‘(i) double-contracting (ii) similarity between mark-up rate in *Murabaha* contracts and interest rate in conventional loans (iii) binding effect of *Murabaha* contract and risk bearing, (iv) time to transfer ownership, and (v) penalty for delay in payment’.⁴⁰ The third point is particularly controversial because it is in breach of the prohibition on *riba* and the fact that Islamic finance is strongly touted as being interest-free.⁴¹

Murabaha has evolved into a complex transaction of three stages, albeit the first two stages are not related to the *Murabaha*.⁴² First, the customer promises to repurchase the proposed property from the bank if purchased. Thereafter, the bank purchases the property and re-sells it to the promising customer.⁴³ The deferred nature of this sale makes it identical to a conventional loan which is against Islamic tenets.⁴⁴ In his critique of *Murabaha*, Usmani opines that the compliance of Islamic finance products with shar’iah products goes beyond mere nomenclature if a product is similar to a conventional loan or contains the elements of *riba* and *gharar*, it is not shar’iah compliant notwithstanding the name given to it. He suggests, therefore, that its use should be restricted only to those cases where *mudarabah* or *musharakah* are not practicable’.⁴⁵

³³ See Hjh Siti Faridah Abd Jabbar citing R. Wilson, "The evolution of the Islamic financial system" (2002) *Islamic Finance, Innovation and Growth*, 32.

³⁴ Jabbar (n 33).

³⁵ Brian Kettel “*Case Studies in Islamic Banking and Finance* (Wiley: 2011) 26.

³⁶ Omar Masood, (n 5) 17.

³⁷ Necmeddin Guney (n 28) 496.

³⁸ Michael Zhou, ‘Giving Moral Advice in Sharia-compliant Finance’ (2014) 27 (3) *Geo J Legal Ethics* 1021, 1034.

³⁹ Hayat, Malik (n 6)68-69.

⁴⁰ Nagoka Shinuke ‘Beyond the Theoretical Dichotomy in Islamic Finance: Analytical reflections on *Murabahah* contracts and Islamic Debt Securities’ (2007) 1-2 *Kyoto Bulletin of Islamic Area Studies* 74.

⁴¹ Shinuke (n 40).

⁴² Necmeddin Guney (n 28) 499.

⁴³ Necmeddin Guney (n 28) 499.

⁴⁴ Usman Hayat, Adeel Malik (n 6) 69.

⁴⁵ M. T Usmani, *An Introduction to Islamic Finance* (Idaratul Ma‘arif 2000) 104-105.

This writer opines that arguments against Murabaha by its critics' borders on the fact that Murabaha, as practiced by banks, is a sort of reverse transaction which is only compliant in Form and not in substance.

In conventional banking the borrower uses the bank loan to finance the purchase of a certain good or product and then repays the loan whereas in Islamic Finance the property is owned by the bank but bought by the customer (as agent) then- principal + mark-up is paid before the property is transferred to the borrower this to me seems like a direct circumvention of the rules against Riba.⁴⁶ Also, contemporary *Murabaha* transactions are identical to conventional banking contracts as the mark-ups charged are either pegged using conventional interest rates or are similar to those used by conventional banks, for this reason, many classical Islamic scholars criticise this product and do not approve of it given the presence of *riba*.⁴⁷

Another, criticism of this product is that contrary to the prohibitions under shari'ah, Islamic Banks are now transferring the risk to customers by trying to avoid all risks that are related to ownership and possession before the final sale to the Client.⁴⁸ This they do by appointing the buyer agent and in so doing, avoids the transactional risk involved in procuring the goods,⁴⁹ this clearly is clearly against the principle of risk sharing in Islamic Finance. Generally, El-Gamal opines that the use of Sharia arbitrage in Islamic Finance has undermined its very essence as it fails to patronage of most middle-class Muslims, increases transactional costs, subject to manipulation by money launderers, potentially self-destructive and dilutes the Islamic brand name.⁵⁰

In defence of contemporary Murabaha, its proponents argue that there is a world of difference between Murabaha and a conventional loan. They argue that unlike conventional loans, Murabaha is an exchange of different goods (commodities for money), the mark-up amount even though pre-determined, is influenced by the market price of the commodity exchanged for cash and any profits gained are as a direct result of the market forces of demand and supply, not the monetary market.⁵¹ Their argument according to Shinuke, is based primarily on a fatwa 'issued at the Al-Baraka seminar held under the auspices of Dallah AlBaraka Group'.⁵² In response to this criticism, other advocates use analogies such as the fact that halal (licit) and haram (illicit) meat are the same in their substance; the main difference being the process of slaughter therefore, inferring that the product engineering is what makes Islamic finance products shariah compliant.⁵³

In my view, the response of the defenders of the contemporary Murabaha is not tenable because the main factor which distinguishes Islamic Finance from other forms of Financing is the prohibitions. The use of means used by conventional banks (LIBOR) to calculate the interest rates in determining the mark-up or profit so in the Murabaha arrangement by Islamic bank strikes me as superficial. Consequently, I am of the view that the Murabaha is simply Islamised

⁴⁶ Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2007) 222; See Also Nagoka Shinuke (2007) 75.

⁴⁷ Kelly Holden, 'Islamic Finance: Legal Hypocrisy Moot Point, Problematic Future Bigger Concern, (2007) 25 B. Int'l L.J. 341.

⁴⁸ Zhou (n 38)(supra); See Also; Necmeddin Guney (n 28) 503.

⁴⁹ Necmeddin Guney (n.28) 504.

⁵⁰ El-Gamal (n 4) 175- 185.

⁵¹ Nagoka Shinuke (n 40) 76.

⁵² Nagoka Shinuke (n 40) 75. See also; Dallah AlBaraka Group, Resolutions & Recommendations of AlBaraka Symposia on the Islamic Economy, Al-Barakah First Symposium, fatwa (No. 8):

<https://www.albaraka.com/media/pdf/Research-Studies/RSMR-200706201-EN.pdf>: accessed 9th May, 2019.

⁵³ Hayat, Malik (n 6) 75.

Hire-Purchase. The re-introduction of interest in the form of profits or mark-up only complies with the letters of Islamic Finance and violates its spirit.⁵⁴

Generally speaking, the continuous modification of conventional banking products to comply and with the rules is a clear indication that products are developed to circumvent the prohibitions under sharia law, this is what EL-Gamal describes as sharia arbitrage.⁵⁵ The continuous use of sharia arbitrage in my view will only diminish the ethical reputation often associated with Islamic Banking as devout Muslims and prospective customers will see beyond the smoke screen of its products.

4.0 **CONCLUSION**

Finally, as earlier discussed⁵⁶the essence of the prohibitions goes beyond structuring of finance and are meant to protect individual members of society. The current practice of *Murabaha* where banks pass the risk associated with the purchase and possession of a property to the customer undermines the essence of the prohibitions. Therefore, the substitution of interest for mark-up is merely a way of circumventing the prohibitions under shariah law.

⁵⁴ Nagoka Shinuke (n 40).

⁵⁵ Necmeddin Guney (n.28) 504.

⁵⁶ Hayat, Malik (n 6) 31.

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