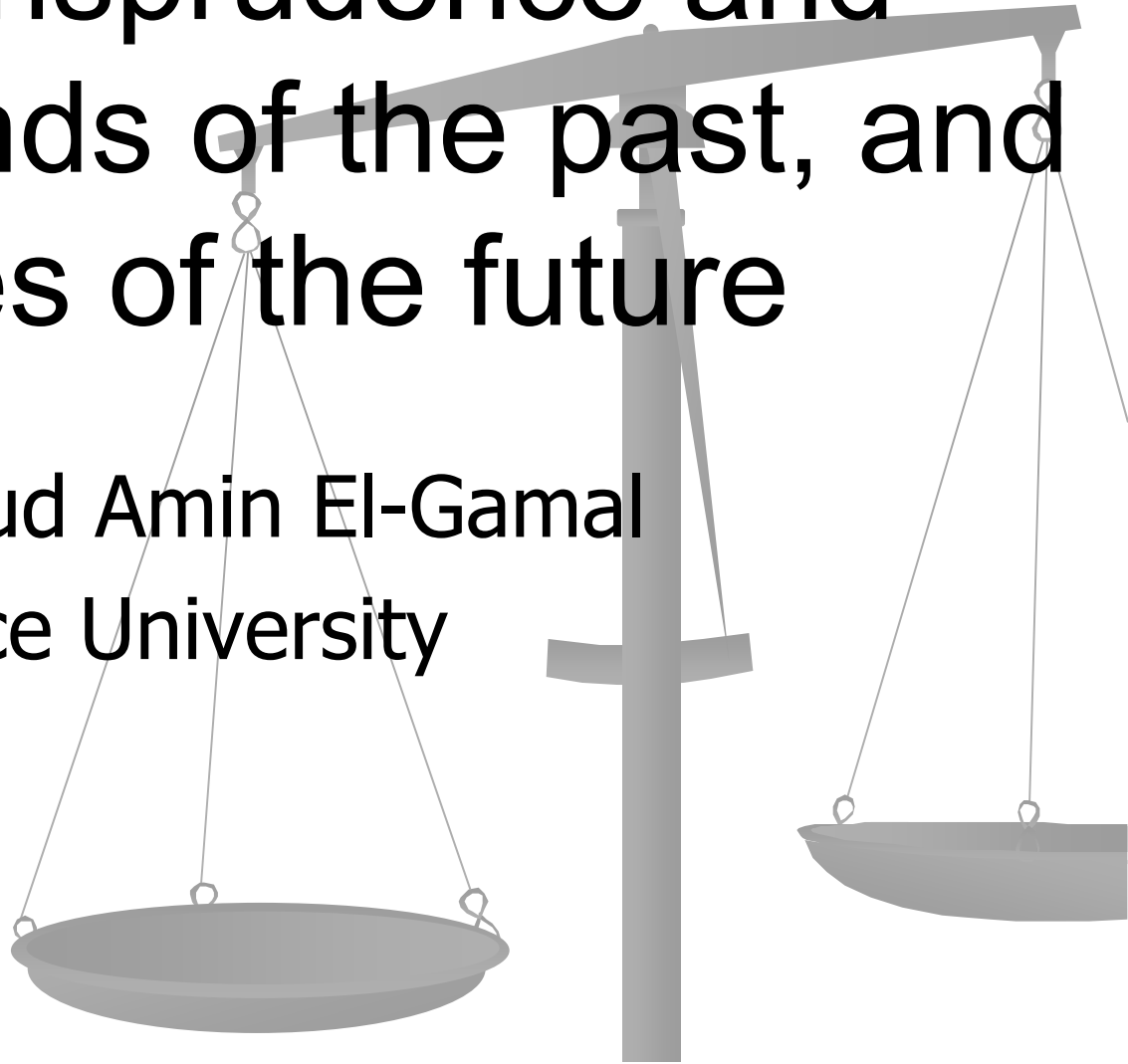
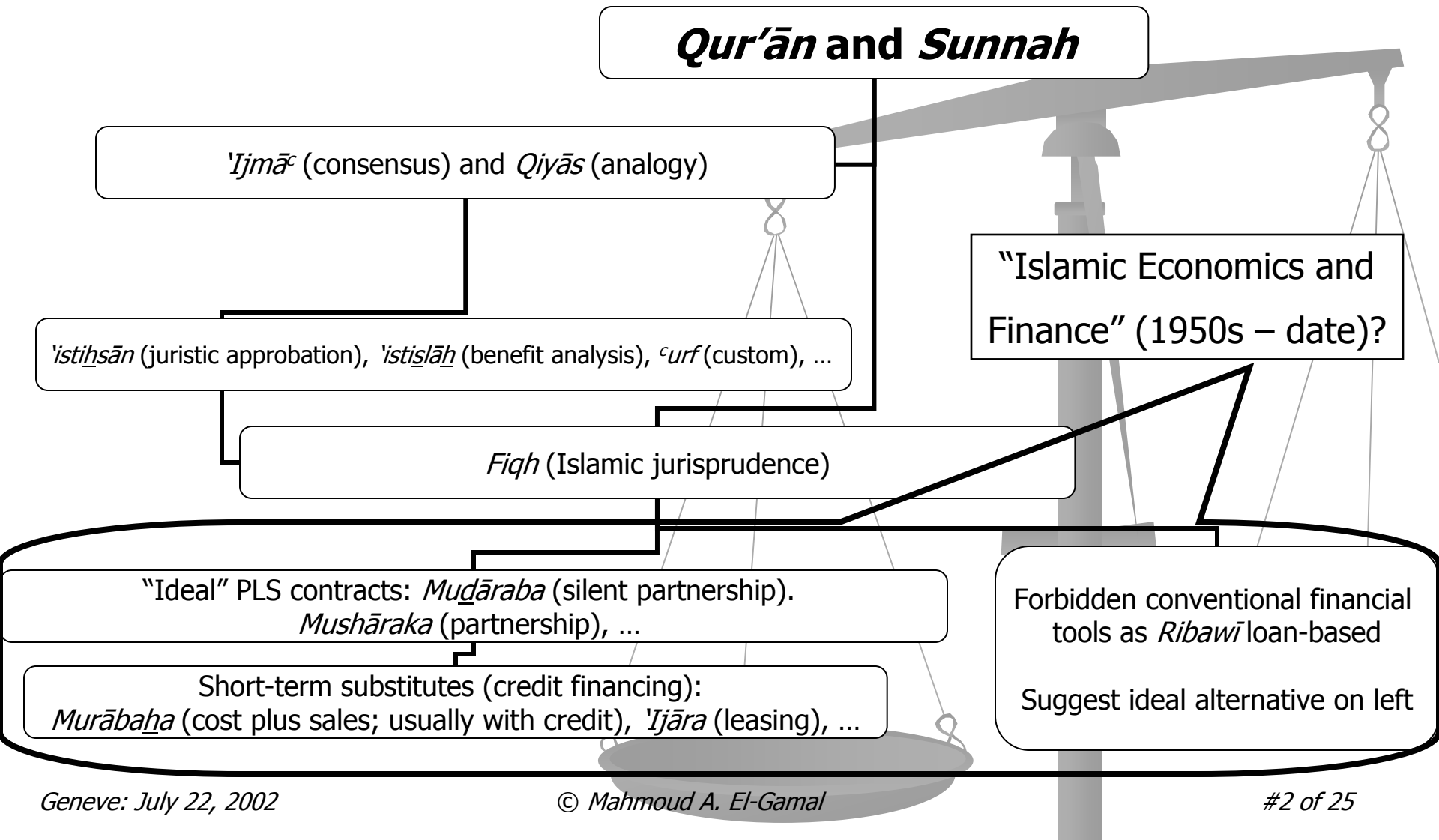


Islamic jurisprudence and finance: Trends of the past, and promises of the future

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Jurists, bankers & economists: The permanent and the changing



Historical “Islamic economics”

- Influenced jurist perceptions of the *علة* (instigating factor) and *حكمة* (wisdom/ objective) of certain prohibitions
 - e.g. myths regarding the prohibition of *Ribā*
 - “fixed rate of return” – what about leasing and credit sales?
 - “return without risk” – what about credit risks and others?
 - “exploitation of the poor” – is still possible.
 - In fact, it appears that the prohibitions of *Ribā* and *Gharar* are built-in prudential financial regulations
 - Prohibition of *Ribā* enforces collateralization + “marking to market”; see <http://www.ruf.rice.edu/~elgamal/files/riba.pdf>
 - Prohibition of *Gharar* enforces optimal “risk-sharing”; see <http://www.ruf.rice.edu/~elgamal/files/gharar.pdf>
- Convinced jurists that there is a viable radically different “Islamic” alternative, but failed to deliver for Islamic banks

What is the forbidden *Riba*?

- *Ribā al-Jāhiliyyah*
- *Ribā al-Nasī'ah*
- *Ribā al-Nasā'* (deferment without increase)
- *Ribā al-Faḍl* (increase without deferment)
 - Muslim narrated on the authority of Abū Saʿīd Al-Khudriy that the Prophet (pbuh) said:
"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt; like for like, hand-to-hand, in equal amounts, and any increase is *Riba*".

} Involve interest

Riba is neither “interest” nor “usury”

- Not all interest is forbidden *Ribā*:
 - permitted cost-plus (*Murābaha*), leasing (*Ijāra*), etc. may contain “interest”.
- Not all *Ribā* is interest:
 - *Ribā al-Nasā’* and *Ribā al-Fadl*
- The percentage does not matter (even 0% can be *Ribā*!)



Main Entry: **¹in·ter·est**

Pronunciation: 'in-t(&-)r&st; 'in-t&-"rest, -"trest; 'in-t&rst

Function: *noun*

Etymology: Middle English, probably alteration of earlier *interesse*, from Anglo-French & Medieval Latin; Anglo-French, from Medieval Latin, from Latin, to be between, make a difference, concern, from *inter-* + *esse* to be -- more at is

Date: 15th century

1 a (1) : right, title, or legal share in something (2) : participation in advantage and responsibility **b** : BUSINESS, COMPANY

2 a : a charge for borrowed money generally a percentage of the amount borrowed
b : the profit in goods or money that is made on invested capital **c** : an excess above what is due or expected <returned the insults with *interest*>

3 : ADVANTAGE, BENEFIT; *also* : SELF-INTEREST

4 : SPECIAL INTEREST

5 a : a feeling that accompanies or causes special attention to an object or class of objects : CONCERN **b** : something that arouses such attention **c** : a quality in a thing arousing interest



Main Entry: **usu·ry**

Pronunciation: 'yü-zh&-rE, 'yüzh-rE

Function: *noun*

Inflected Form(s): *plural -ries*

Etymology: Middle English, from Medieval Latin *usura*, alteration of Latin *usura*, from *usus*, past participle of *uti* to use

Date: 14th century

1 *archaic* : **INTEREST**

2 : the lending of money with an interest charge for its use; *especially* : the lending of money at exorbitant interest rates

3 : an unconscionable or exorbitant rate or amount of interest; *specifically* : interest in excess of a legal rate charged to a borrower for the use of money

The prohibition of *Riba* is *not* merely exploitation prevention

■ Yūsuf ʿAlī translation:

- [2:279] ... but if ye turn back, ye shall have your capital sums; Deal not unjustly, and ye shall not be dealt with unjustly.
- This translation gives the wrong impression about the meaning of the verse "...*lā tazlimūna wa lā tuzlamūr*", as explained by Ibn ʿAbbās, Abū Jaʿfar, and others. A correct translation as per the explanation in Ṭabarī and elsewhere:
- ... but if you turn back, then you should collect your principal, with no addition or subtraction.

Debunking the “kindness” explanation

- T-D Al-Subkī in the continuation of Al-Nawawī’s *Al-Majmūc* reports an opinion of ibn Kayyisān that the reason for the prohibition of *Ribā* is based on kindness.
 - Proves it faulty by considering increase in trading non-*Ribawī* goods.
- Consequences of the faulty explanation:
 - wrongly extends prohibition to permitted trades
 - wrongly permits non-exploitative forms of *Ribā*

The prohibition of *Riba* is not about “return without risk”

- How about credit risk, and “rate of return” risk
- Faulty application of the *Hadīth*/juristic rule “*al-kharāju bi-d-Damān*”
 - Context: “*kharāju l-^cabdi bi-Damānih*”: returns belong to the one bearing the risk.
 - If understood as: “returns-earned must be commensurate with risk-taken”, the statement is either a tautology, or does not apply to *Murābaha* with very brief risk-exposure time period.

The prohibition does not negate “time value of money”

- Logically, the return in *Murābaḥa*, *Ijāra*, etc. is permitted “interest” (check your Webster’s)
- “*Māl*” does grow (eligible for *Ribā* and *Zakāh*)
- Al-Sarakhsī, Al-Kāsānī, Al-Zayla‘ī, ibn ‘Abidīn:
 - “The price may be increased with deferment.”
- Al-Shāṭibī, ibn Rushd, Al-Dardīr, Al-Nawawī, Al-Sāwī, Al-Shirbīnī, ibn Taymiya:
 - “Time has a share in the price.”
- Al-Shāfi‘ī, Al-Ghazālī:
 - “What is worth 5 in cash is worth 6 deferred”.

The loan (qard) contract

- A debt may originate from a sale (*bayʿ*), a lease (*'ijāra*), a forward (*salam*), etc. or from a loan (*qard*)
- Loans are charitable contracts: forfeit ownership of the usufruct of the asset to help another
- If used as a finance mechanism (as commutative financial contracts), they violate the prohibition of *ribā al-Nasā'*, even if they are interest free!
- The "rate of return" on a *qard hasan* is Unknown

Can borrowing which seems to be mutually beneficial be harmful?

- Most people
 - Prefer \$100 today to \$101 tomorrow;
and prefer \$101 in 51 days to \$100 in 50 days ?
 - Prefer \$9 today to \$12 in a year;
and prefer \$4000 in a year to \$3000 today?
 - Discount future losses more than they discount future gains?
 - Discount delays more than they discount speedups?
- They suffer from ***Dynamic inconsistency***

Dynamic inconsistency

- If you knew that a juicy steak was bad for you while a salad was good for you:
 - Would you go to a steakhouse that serves great salads, or go to a salad restaurant to avoid the temptation?
 - How else can you ensure that you will not eat a steak?
- The solution is through “precommitment”

Dynamic inconsistency

- There are many individuals who:
 - Borrow today with the intention to save and payoff debts next year, ... but
 - When next year comes, borrow even more!
- The solution is precommitment:
 - In Islamic finance, debts are tied to the value of the financed asset,
 - Creditors are forced to avoid debt cycles (in contrast to conventional credit card issuers).

Precommitment to “mark to market”

- **ibn Rushd’s *Bidāyah* + the *Hadīth* of Bilāl:**
 - “Marking to market” ensures that trading ratio = $1/\text{ratio of prices} = \text{ratio of marginal utilities}$
 - This ensures (Pareto) efficiency, a dominant economic notion of fairness in exchange:

“It is thus apparent from the law that what is intended by the prohibition of *Ribā* is what it contains of excessive injustice (*ghubn fāhish*). In this regard, justice in [exchange] transactions is achieved by approaching equality. Since the attainment of such equality in items of different kinds is difficult, their values are determined instead in monetary terms (*with the Dirham and the Dīnār*).

For things that are not measured by weight and volume, justice can be determined by means of proportionality. I mean, the ratio between the value of one item to its kind should be equal to the ratio of the value of the other item to its kind.

For example, if a person sells a horse in exchange for clothes, justice is attained by making the ratio of the price of the horse to other horses the same as the ratio of the price of the clothes [for which it is traded] to other clothes. Thus, if the value of the horse is fifty, the value of the clothes should be fifty. [If each piece of clothing's value is five], then the horse should be exchanged for 10 pieces of clothing.

As for [fungible] goods measured by volume or weight, they are relatively homogenous, and thus have similar benefits [utilities]. Since it is not necessary for a person owning one type of those goods to exchange it for the exact same type, justice in this case is achieved by equating volume or weight since the benefits [utilities] are very similar...”

Ibn Rushd, M. *Bidāyat Al-Mujtahid wa Nihāyat Al-Muqtasid*, Dār Al-Maʿrifah, Beirut, 1997 (vol.3, pp.183-184)

Precommitment to “mark to market” and control indebtedness

- For *Ribā Al-Nasī’ah*, “Islamic” alternatives:
 - Force the “interest rate” in a financing contract to be equal to the market determined opportunity cost of similar “opportunities” (same risk profile, market-based residual value, etc.)
 - Encourage equity-based financing, which ensures another form of precommitment

The forbidden *bay`u al-Gharar*

- Jurisprudence and Prophetic Traditions :
 - Ambiguity in contract language: e.g. two sales in one
 - Unnecessary uncertainty: e.g. sale of the diver's catch
 - Undeliverable merchandise: e.g. sale of birds in the sky
- Al-Bājī: "sale that is dominated by *gharar* ()"
- Professor Mustafa Al-Zarqā':
 - "*Gharar* is the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling"
- Professor Al-Darīr:
 - *Gharar* only invalidates (i) commutative financial contracts, (ii) in which it is substantial, (iii) integral to the contract, and (iv) for which there is no viable substitute.

Bayʿu l-Gharar = trading in risk

- **Etymology:** risk = *re-secare* (potential for loss) = *risque*
 - [a ship's] chance of being cut by a rock, definition of Qadī ʿIyād.
- **Economics and Jurisprudence:** Risk (*gharar*) vs. uncertainty (*jahāla*); Al-Qarāfī (*Al-Furūq*):
 - “The definitions of *gharar* and *jahāla* are each more general in some respects and less general in others. This is the reason for the scholars’ differences over the respective natures of *gharar* and *jahāla*”.
- **Jurisprudence:**
 - Trading in risk is the essence of insurance and other “sale-based” hedging mechanisms
 - Fatwa ʿIbn ʿAbidīn forbidding marine insurance
- **Options for risk allocation: selling vs. sharing risk**
 - Pricing is problematic due to loss aversion and other complications

Standardized Named Contracts

- Asset-based financing (no *Ribā*):
 - *Murābaḥa* = cost-plus sale
 - *Bayʿ bi-thaman 'ājil* = credit sale
 - *'Ijāra (wa -qtinā')* = Lease (to purchase)
- Risk-sharing mechanisms (no *Gharar*):
 - *Mudāraba* = silent partnership (*commenda*)
 - *Mushāraka* = simple partnership
- Exceptions (*Istihsān*, *Urf* or *Maṣlaḥa!*):
 - *Salam* = forward with pre-paid price
 - *'Istiṣnāʿ* = Commission to manufacture
- Named contracts are mostly pre-Islamic
- Through *futyā* and *qadā'*, new contracts were legitimized *ex post* by jurists
- Legal fine-print to avoid *Ribā* and *Gharar* was documented in jurisprudence

“Convention” (العرف) in named contracts

Appeals to “convention” (العرف) reference count:

- *Al-Mabsūt* (Al-Sarakhsī, *Hanafī*) 130 references
- *Badā’i’ Al-Sanā’i’* (Al-Kāsānī, *Hanafī*) 95 references
- *Radd Al-Muhtār* (ibn-^cĀbidīn, *Hanafī*) 237 references
- *Sharh Mukhtasar Khalīl* (Al-Kharshī, *Mālikī*) 1182 references
- *Al-Majmūc* (Al-Nawawī + Al-Subkī, *Shāfi’ī*) 60 references
- *Al-Mughnī* (ibn-Qudāma, *Hanbalī*) 102 references

Appeals Relate to all contracts, including:

- Deposit contracts: even if unrestricted, are restricted by عرف
- Acceptable forms for partnership capital: determined by عرف
- Acceptable conditions in contracts (esp. leases and credit sales):
- Typical phrases:
“العرف معتبر في الإجارة” and
“عرف التجار معتبر في المرابحة”
(e.g. many of the lease restrictions imposed by today’s *Sharf’a* boards are based on ibn-^cĀbidīn’s acceptance of leasing conventions in Damascus, two centuries ago).

Problems with “Form above function?”

in juristic analogy (قياس فقهي)

- Consider contracts **A** and **B**, one forbidden and the other permissible based on juristic analogy (قياس فقهي).
- If contracts **A** and **B** are shown to be economically identical (in the Arrow-Debreu sense; $A \equiv B$), do we:
 - Forbid **B**, through the apparent analogy (قياس شبهه)?
 - Permit **B**, while forbidding **A** → allows for the fallacy of composition; avoids iterative analogy = (قياس على قياس)?
 - Or, revoke the earlier false juristic analogy based on the economic analysis of its proof (دليل) and reasoning (علة)?

- The fallacy of composition and “Islamic Financial engineering”:
 - If $A \equiv B + C$, and the jurists forbid **A**, see if they accept **B** and **C** (e.g. *sukūk al-salam*, *Murābaha lil’āmir bishshriā*)
 - If **B** is forbidden, but **A** is permissible, and $A \equiv B + C$, try to get jurists to accept **C** (e.g. synthetic embedded options)
 - Search the historical books of jurisprudence for **A**, **B** or **C**
- In all cases, charge the customer a premium for the relatively inefficient “Islamic” (or “Islamized”) alternative:
 - Islamic finance as *Sharī‘ā* arbitrage
 - Primary beneficiaries: lawyers

Sharfā arbitrage:

- Marketing Islamic finance to customers as “fundamentally different”, and to regulators as “essentially the same”:
 - OCC #867, 1999 : “... lending takes many forms ... Murabaha financing proposals are functionally equivalent to, or a logical outgrowth of secured real estate lending and inventory and equipment financing, activities that are part of the business of banking.”
 - OCC #806, 1997: “Today, banks structure leases so that they are equivalent to lending secured by private property... a lease that has the economic attributes of a loan is within the business of banking. ...Here it is clear that []’s net lease is functionally equivalent to a financing transaction in which the Branch occupies the position of a secured lender...”

The need for “logical analogy” (قياس) and basic research

- The established rulings in classical jurisprudence are of limited usefulness:
 - What was deemed permissible two centuries ago may result in forbidden *Ribā* in today’s financial environment
 - What was deemed forbidden two centuries ago may be permissible within today’s legal and regulatory framework
- *Sharfā* arbitrage is only profitable in the very-short-run (by definition), and self-defeating in the long-run (increased integration