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Jurisprudence and Arbitrage

The previous chapter highlighted the irony in reports that "Islam forbids interest" or "the Qur'an forbids interest," followed by a statement of the interest rate paid by Islamic instruments (e.g., *sukuk*). Some practitioners may be more cognizant of this problem and choose to report that the "profit rate" or "return" paid on their interest-free bond is a fixed 4 percent, or floating LIBOR plus 50 basis points. Indeed, many Islamic finance practitioners would be genuinely offended if someone asked them about the interest rate they charge, say, on Islamic mortgages. They may be slightly less offended if asked about "the implied interest rate," computed from the deferred price they charge in a credit sale, or the rent they charge in a lease-to-purchase or declining-partnership agreement.

Such discrepancies between rhetoric and practice are not only problematic from an intellectual standpoint. They also lead to disillusionment with the industry for many educated Muslims, who may otherwise be its primary customers. Similarly, this rhetoric drives away many conventional financial providers, who could otherwise be the primary providers of Islamic financial services. To those practitioners, it is clear that there is no such thing as finance without interest. They find endless "research" on whether or not discounting is allowed in Islam to be silly and decide to ignore the industry altogether. Last but not least, this rhetoric encourages a pietist antirational approach to the field, as shown by the previous chapter's quotation from the *Fortune* magazine article that "God is in the details."

The long-term solution to this problem requires substance-oriented revival of Islamic jurisprudence. This would in turn require an economic analysis of classical Islamic jurisprudence to uncover the substantive considerations that gave rise to premodern Islamic contract forms. A comprehensive economic analysis of Islamic theories of property, contract, tort, and the like is beyond the scope of this book. However, to understand the short-term inadequacy of Islamic finance as currently practiced, the reader needs to acquire a basic understanding of the nature of Islamic law and jurisprudence in the premodern and contemporary periods. A brief summary of Islamic jurisprudence is provided in this chapter, and an in-depth analysis of the two prohibitions that define the character of contemporary Islamic finance is provided in Chapter 3. The goal of both chapters is to illustrate that the form-oriented nature of Islamic finance as practiced today is unjustified. As we shall see, the objective of classical Islamic jurisprudence has been to enhance economic efficiency, according to the best benefit analyses of premodern jurists. Thus, contemporary adherence to inefficient premodern forms is insufficient for earning the "Islamic" brand name.

2.1 Islamic Law and Jurisprudence

We have asserted in Chapter 1 that Islamic jurisprudence is in fact a common-law system, built primarily on analogy to precedents. In fact, religious rhetoric and formal Sunni Islamic legal theory dictate that permissible juristic inference is restricted to analogies in relation to the Islamic canon. However, we shall see that, in reality, good classical jurisprudence of financial transactions was driven by benefit analyses, which were sometimes disguised by the characteristic formalism of juristic analogy and reference to the canon.

The Canon: Qur'an, Tradition, and Consensus

The primary canonical text of Islam is the Qur'an (lit. The Recitation), which is self-referentially called "The Book."[1] Indeed, accounting for average verse length and repetitions of nonlegal verses, Goitien (1960) has shown that the relative legal content of the Qur'an is not less than its counterpart in the Torah, which is often called "The Law."[2] Thus, Islamist rhetoric suggests that the Qur'an is at least in large part a legal document that should be applied.

However, careful reading shows that most Qur'anic legal verses (especially outside the domain of criminal penalties) tend to be general in nature, with few detailed exceptions on issues of marriage and inheritance. For instance, in the economic realm, the Qur'an orders believers to fulfill their contractual obligations [5:1] and declares generally that "God has permitted trade and forbidden *riba*" [2:275].[3] However, the Qur'an does not state clearly which contracts are valid, and thus must be kept, and which are invalidated and voided (e.g., based on the prohibition of *riba*).[4]

In this regard, it is useful to recall the following statement of ʿAli ibn Abi Talib, the fourth Caliph. When asked to let the Qur'an arbitrate his political dispute with Muʿawiyah ibn Abi Sufyan, he said famously: "The Qur'an does not speak; men [claim to] speak on its behalf." Legal content of the Qur'an thus required explanation through Prophetic *Sunna*, as well as juristic analyses in later centuries.[5]

The Prophetic *Sunna* consists of reported sayings and actions of the Prophet, as well as the practices that he witnessed and approved implicitly.[6] Al-Shafiʿi (1939) established Prophetic *Sunna* as a legal source of equal authoritativeness to the Qur'an.[7] Although the Qur'an was reportedly recorded in writing very early in Islamic history, reports of the Prophetic *Sunna* survived for centuries in the form of oral tradition. This allowed for contradictory traditions to exist and left room for jurists to disagree over means of reconciling them to reach appropriate legal rulings.

Al-Shafiʿi (1939) further argued that consensus over a ruling elevates it to the canonical level.[8] However, most jurists ruled that local consensus of scholars in a particular country or region is not deemed authoritative.[9] Together with the possibility of dissent by unknown parties, this effectively limits viable invocation of the principle to consensus reached during the early Islamic period. Moreover, Islamic legal theorists have argued that consensus based on juristic inference is not permanently part of the canon, since it may be abrogated by later juristic inference constructed for different circumstances or based on different analysis.[10]

Juristic Inference (Ijtihad) and Benefit Analysis

In the absence of legislative canonical texts or canonized consensus, jurists had to resort to some process of juristic inference. Most Sunni jurists have agreed formally to limit juristic inference to reasoning by analogy, following Al-Shafiʿi (1939, p. 477). The general term for juristic analysis is *ijtihad*, which literally means "doing one's utmost" (to reach the most appropriate ruling). Earlier juristic methods of approbation (*istihsan*, mainly in the Hanafi school), benefit analysis (*istislah*, mainly in the Maliki school), and reliance on local customs (ʿ*urf*) were thus denounced by Al-Shafiʿi as illegitimate forms of human legislation.[11] Strict adherence to reasoning by analogy has played an important role in the development of an inefficient Islamic finance industry focused on premodern nominate contracts. However, careful examination of classical jurisprudence shows that many of the best classical jurists based their rulings mainly on benefit analyses that were guided by their economic understanding.

In this regard, Zahiris (those who only adhere to apparent meanings of canonical texts) and Shiʿi schools officially continued to allow their jurists to utilize any means of inference on matters not directly addressed by the Islamic canon. However, the freedom accorded Shiʿi jurists – which theoretically permitted them to use reason (ʿ*aql*) without restriction to formal analogies – was tempered by the principle of caution (*ihtiyat*) to ensure adherence to the paths of their Imams.[12]

Moreover, the notion of following or imitating (*taqlid*) the opinions of a learned jurist (*marjiʿ fiqhi*) is also very similar to the concept of following a particular jurist or a particular school of jurisprudence in Sunni Islam. Finally, while Shiʿi jurisprudence has traditionally had a formal hierarchy of jurists, Sunni Islam in various countries has developed similar hierarchies through, for example, posts of grand muftis and memberships of various prestigious jurisprudence academies. Consequently, the structural dynamics of mainstream Shiʿi and Sunni jurisprudence have shown many more similarities than differences.

Indeed, although Sunni jurists are formally required to restrict their inference to reasoning by analogy, effective jurists of the main Sunni schools have managed to base their rulings on benefit analysis and other rational devices. For instance, Hanafi jurists continued to use juristic approbation by rephrasing it in terms of "abandoning the most apparent analogy in favor of more subtle hidden analogy," or appealing to the rule of necessity. Maliki jurists did not even search for hidden analogies, simply rejecting apparent analogies if their resulting rulings contradicted customary practice, prevented apparent benefits, or led to significant harm.[13] In this regard, the Maliki jurist-philosopher Ibn Rushd (d. 594 A.H./1198 C.E.) equated Hanafi juristic approbation and Maliki benefit analysis thus: "in most cases, juristic approbation means consideration of benefits and justice."[14]

In general, jurists enumerated four criteria for invoking benefit analysis: (1) allowing apparent benefit, (2) preventing apparent loss/harm, (3) preventing means of circumventing the Law, and (4) consideration of specific circumstances in time and place.[15] Jurists also had to decide on priorities when benefit analysis contradicted the apparent meanings of canonical texts (Qur'anic verse or Prophetic tradition). Islamic legal theorists addressed this problem by classifying canonical texts into (1) specific (dealing with a particular case) versus general ones and (2) well-established (in terms of meaning and authenticity) versus vague or inauthentic ones. Although all schools of Sunni jurisprudence disallowed overruling an explicit and specific canonical ruling, they differed in opinion regarding areas wherein some jurist discretion was allowed (e.g., to restrict general rulings based on benefit analysis). In this regard, the Hanafi and Maliki schools were the most liberal in using benefit analysis, and the Shafiʿi and Hanbali schools were the most conservative.[16] However, one must be careful not to jump to the conclusion that the Hanbali school (which is dominant in the GCC region) is the strictest in practice. Indeed, it is only within the Hanbali school that some jurists approved the practice of *tawarruq* (a three-party multiple sale to synthesize interest-based lending, as discussed in Chapter 4), whereas luminaries of the Hanafi school – including Abu Hanifa's associate Al-Shaybani – condemned the practice unequivocally.[17]

Thus, we have seen that benefit analysis should guide the development of Islamic finance, rather than formalist analogy to premodern practices. In this regard, the great twentieth-century Azhari jurist and legal theorist ʿAbdul-Wahhab Khallaf clearly stated that benefit analysis should be the final arbiter in the area of financial transactions: "Benefit analysis and other legal proofs may lead to similar or different rulings. . . . In this regard, maximizing net benefit is the objective of the law for which rulings were established. Other legal proofs are means to attaining that legal end [of maximizing net benefits], and objectives should always have priority over means."[18]

The undiscriminating quest in Islamic finance to replace "conventional," that is, contemporary, financial practice is particularly perplexing, given that classical jurists considered adherence to convention (*ʿurf*) to be an important legal consideration. In fact, there are five general rules in *Majallat Al-Ahkam Al-ʿAdliyya* (Ottoman codification of Hanafi jurisprudence circa 1293 A.H./1876 C.E.) that directly contradicted canonical texts and were defended by jurists on the basis of hardships in altering customary practice.[19] Similarly, the great Hanafi jurist Al-Sarakhsi wrote in *Al-Mabsut* the general principle that "establishment [of rights, etc.] by customary practice is akin to establishment by canonical texts."[20] In addition, recognizing that conventions change from one historical period to another, the 39th article of *Majallat Al-Ahkam Al-ʿAdliyya* stated that juristic rulings must keep up with the times.[21]

Consequently, the bias in contemporary Islamic finance should be for maintaining conventional practice, rather than seeking alternatives thereof, especially if those alternatives are inefficient. In this regard, many of the contemporary practices in conventional finance already have built into them protections that were intended by classical juristic rulings. Thus, instead of seeking to replace the mechanics of conventional financial practices with inefficient analogs synthesized from premodern contract forms, Islamic finance should focus on the substance of Islamic Law with regard to how financial instruments are used, rather than how they are constructed.

2.2 From Classical to Contemporary Jurisprudence

The history of Islamic jurisprudence is customarily divided into eight periods.[22] The first period ended in 11 A.H./632 C.E., when revelation stopped with the Prophet's death. The second period, characterized by personal interpretations of the canon by the Prophet's companions, lasted until 50 A.H./670 C.E.[23] From the year 50 to the early second century A.H., tension emerged between a traditionist approach to jurisprudence in western Arabia and a rationalist approach in Iraq. This gave rise to the golden age of classical Islamic jurisprudence, which extended from the early second to the mid-fourth century A.H. The eight most significant schools of Sunni and Shiʿi jurisprudence emerged during that period.[24]

From the mid-fourth to mid-seventh century A.H., Islamic jurisprudence was limited to elaborations within the main juristic schools. Then began the dark age of Islamic jurisprudence, following the fall of Baghdad to the Tatars in the mid-seventh century A.H. (thirteenth C.E.). Rebirth of jurisprudence occurred in 1293 A.H./1876 C.E., when the Ottomans codified Hanafi jurisprudence in the *Majalla*. From the late nineteenth to the mid-twentieth century C.E., a number of juristic revival movements began, following exposure to Western legal and technological progress. This period produced progressive jurists such as Muhammad ʿAbduh and legal pioneers such as ʿAbdal-Razzaq Al-Sanhuri, who aimed to reinterpret classical jurisprudence in modern form. In the latest episode of Islamic revival, which began in the mid-twentieth century C.E., Islamist trends have been predicated on rejection of Western social and legal advances and a quest for building Islamic states, Islamic social science, Islamic economics, and Islamic finance. As a result, classical (premodern) jurisprudence is mostly read uncritically today, and attempts to adhere to its conditions have given rise to inefficiencies and rent-seeking Shariʿa arbitrage activities.

Jurisprudence, Revival, and Codification

For Islamic societies to go beyond formalistic adherence to premodern jurisprudence, they needed to revive the substance of classical Islamic jurisprudence in an enlightened modern manner. Some contemporary jurists have made efforts in that direction, such as Al-Qaradawi (1996). His and similar proposals for renewed juristic inference have centered mainly on the notion of "collective *ijtihad*," in order to overcome classical taxonomies of jurists and their authorities. In the classical hierarchy of jurists, the two top categories of unconstrained-independent and unconstrained-dependent jurists (the difference being that the former type develop their own legal methodology) are generally restricted to the great Imams of the golden age of jurisprudence.[25] Thus, the only recognized categories of jurists today require varying degrees of dependence on classical jurisprudence. However, proponents of reviving *ijtihad* argued, groups of jurists may attain sufficient modern authoritativeness through collaboration.

Calls for such collective *ijtihad* began shortly after the fall of the Ottoman empire, which had codified Hanafi jurisprudence in the year 1293 A.H./1876 C.E. and imposed the code as *Majallat Al-Ahkam Al-ʿAdliyya*. When the Ottoman empire fell after World War I, that code had become outdated, and many regions sought to apply juristic principles in transactions law that were more liberal than those of the strict Hanafi school.[26] To provide appropriate forums for collective *ijtihad*, various Islamic countries began to establish national as well as multinational juristic councils.[27] Most prominent among those councils were the Institute of Islamic Research (Majmaʿ Al-Buhuth Al-Islamiyya) at Al-Azhar University (established in Cairo, 1961), the Islamic Jurisprudence Council (Al-Majmaʿ Al-Fiqhi Al-Islami) of the Muslim World League (established in Makka, 1979), and the Fiqh Academy (Majmaʿ Al-Fiqh Al-Islami) of the Organization of Islamic Conference (established in Jeddah, 1984). It was within this framework that "Islamic finance" was born in the mid-1970s, backed by a series of juristic rulings from the various international juristic councils, as well as national councils and independent Shariʿa supervisory boards. Those boards in part rely on general rulings issued by the international jurisprudence councils, and some members of those boards simultaneously serve on or advise those councils.

In recent years, bank-sponsored institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have put in place their own Shariʿa boards to set general standards for contracts used in Islamic finance. The jurists serving on AAOIFI's board constitute a major subset of the jurists serving on Shariʿa boards of various financial institutions. Moreover, some of those jurists serve on the major multinational juristic councils mentioned above, and others serve as expert witnesses who help to shape the opinions of those councils. Thus, there is today a small number of jurists retained by and directly advising and supervising Islamic financial providers, setting standards at institutions such as AAOIFI, and engaged in global collective *ijtihad* to define the nature of contemporary Islamic financial jurisprudence. One of the most important aspects in this contemporary *ijtihad* is its reliance on the classical institution of *fatwa* (elicitation of juristic response to a question, modeled after the Roman system of *responsa*). In this regard, the bulk of finance-related questions considered by the various juristic bodies are posed to them by practitioners of Islamic finance.[28]

Institution of Fatwa and Islamic Finance

The institution of *fatwa* has been central to the development of jurisprudence, dating back to the time of the Prophet, whose answers to various legal questions are codified as part of the Islamic canon. In later decades the Prophet's companions fielded questions on all aspects of Islamic law, often leading to codification of their opinions as "consensus of the early community in Madina." During those early periods, the two institutions of *fatwa* (providing nonbinding answers to legal questions) and *qada*ʾ (court legal rulings) were confounded to some extent. In later periods the two institutions became clearly distinct, with *qadis* (state-appointed court judges) legislating through *qada*ʾ, and *muftis* of official or unofficial status legislating to those who accepted their opinions through the institution of *fatwa*. In the Muslim world, a vacuum ensued in the areas of *qada*ʾ and official jurisprudential codification following the Ottoman empire's fall after World War I. Consequently, the institution of *fatwa* effectively became the only vehicle for legislation in Islamic jurisprudence of financial transactions.

In this regard, *fatwa* played a central role in the birth of Islamic finance. The proposals of Humud (1976) inspired a *fatwa* at the First Conference of Islamic Banks (Dubai, 1979), which ushered the birth of contemporary Islamic banking. This *fatwa* (based on an otherwise obscure opinion of the Maliki jurist Ibn Shubruma) stated that an Islamic financial institution may require its customer to sign a binding promise that he will purchase the financed property on credit (with an agreed-upon mark-up) once the bank buys it based on his order. The resulting contract came to be known as *murabaha l-il-ʾamir b-il-shira*ʾ (mark-up sale to the one who ordered the purchase).[29] Further modifications in this contract allowed banks to assign the eventual buyer as buying agent (to purchase the property on behalf of the bank), as well as selling agent (to sell the property to himself, again on behalf of the bank).

This *fatwa* is similar to other Islamic-finance-related *fatawa* in many respects: Bankers, lawyers, and other practitioners in the field of Islamic finance pose questions to members of juristic councils, or their own retained Shariʿa supervisory boards. Jurists then rule whether or not the transaction as described to them is permissible, and if not, what permissible alternatives may be available. Some of those *fatawa* are advertised publicly,[30] whereas others issued by Shariʿa boards of Islamic financial institutions may be kept confidential.[31]

We have noted in Chapter 1 that Islamic jurisprudence of financial transactions in fact proceeds as a common-law system, relying on precedent and analogy. In the above-mentioned central *fatwa*, which allowed Islamic finance to grow in the late 1970s, the precedent of Ibn Shubruma's opinion was required to justify a practice that contemporary jurists would have found difficult to base directly on canonical texts. Note, moreover, that within the institution of *fatwa*, jurists contemplate only questions posed to them. In this regard, the questioner has a decisive primary-mover advantage in choosing the question and its wording.

Consider, for instance, the manner in which an Islamic bank can offer a liquidity facility to a customer who did not wish to buy a capital good that can serve as collateral. In fact, a number of Islamic financial institutions, including some of the most conservative, structured unsecured corporate lending practices often in terms of *murabaha*. Thus, if a customer needed to borrow $1,000,000, and the "Islamic bank" was willing to lend him $1,000,000 at 5 percent interest, a simple intermediary trade solved the problem of Islamicity: The bank bought $1,000,000 worth of a commodity with relatively stable prices over the short term (e.g., some metal traded on a commodity exchange) and then sold the commodity to the customer on credit, with a deferred price of $1,050,000. This transaction falls within the framework of *murabaha* financing and thus would be approved by the bank's Shariʿa board with little hesitation, given the centrality of *murabaha* to Islamic banking practice since its inception.

Of course, the customer may have no interest in the commodity except to turn around and sell it for $1,000,000 (perhaps less a brokerage fee), thus obtaining the desired liquidity. Interestingly, in two celebrated *murabaha* cases (Islamic Investment Company of the Gulf v. Symphony Gems NV in 2002, and Beximco Pharmaceuticals v. Shamil Bank of Bahain EC in 2004), plaintiffs attempted to use the argument that the credit facilities were in fact interest-bearing loans and thus did not adhere to the Shariʿa, as stipulated in the contracts. In both cases, English courts ruled exclusively according to English law, deeming Shariʿa issues nugatory, since contract provisions did not stipulate applying the law of any recognized sovereign state. Thus, the Islamic banks in both cases received their principals plus interest on the synthetic loans.

The transaction costs associated with multiple metal trades were sufficiently small for corporate customers borrowing large sums of money. Thus, *murabaha* structures were sufficient for this purpose and utilized for decades. However, to cater to small borrowers at the retail level, Islamic banks in GCC countries needed to reduce those transaction costs. Thus, they resorted to the transaction known as *tawarruq* (literally: monetization), which was approved by a number of Shariʿa boards of Islamic financial institutions, based on its acceptability to some Hanbali jurists. In Chapter 4 we shall discuss the mechanics of *tawarruq*, which allow for lower transaction costs and raise a number of reservations, even for Hanbali jurists who had approved the contract's limited and unsystematic utilization. The practical difference between *murabaha* and *tawarruq* is quite minimal: The latter makes the final sale for cash a formal part of the transaction, often conducted by the bank on its customer's behalf. Of course, for the retail customer, this "innovation" allows better approximation of conventional bank products, as multiple trades are performed in the bank's back office, and the customer merely gets the interest-bearing loan amount in cash (rather than aluminum).

Thus, at the initiative of bankers, progressively smaller groups of jurists have issued *fatawa* that allowed progressively closer approximations of conventional banking practice: (1) In the 1970s and 1980s, large numbers of jurists approved *murabaha* financing as a de facto form of secured lending, (2) in the 1980s and 1990s, smaller numbers of jurists allowed commodity-purchase *murabaha* financing to provide de facto unsecured loans to corporate customers, and (3) in the early 2000s, a small group of GCC jurists have allowed unsecured lending to retail and corporate customers through *tawarruq*. Similarly, as we shall see in Chapter 6, multiple-sale-based bond structures were approved and used by the

Bahrain Monetary Agency to issue treasury-bill-type debt instruments. The gradual progression in approximation of conventional financial products (loans and bonds) illustrates the fundamental role bankers and lawyers play in the development of Islamic jurisprudence itself (rather than merely the Islamic finance built thereupon).

Thus, the combination of form-oriented jurisprudence and first-mover advantage given to financial industry practitioners has enabled those practitioners to shape Islamic jurisprudence of financial transactions for future generations. Indeed, the current generation of observing Muslims have already grown accustomed to reading religious books that list *murabaha* and the like as Islamic modes of finance. This makes it difficult for future jurists to develop a sensible jurisprudence that is both efficient and Islamic. A frequent argument made by industry jurists and practitioners states that one had to start somewhere. Even if the current modes of Islamic finance are imperfect, the argument goes, they are a good starting point toward developing a bona fide juristic understanding and accompanying Islamic financial industry. However, the history of Islamic finance belies that optimistic vision. As we cover most aspects of Islamic finance in this book, it will become painfully obvious that the modus operandi of this industry – rent-seeking Shariʿa arbitrage – is incapable of developing new products and services, and impervious to calls for adherence to the substance of Islamic law. Thus we end up with inefficient finance (that chases past returns) without the substantive personal protections of religious law and de facto codification of bad jurisprudence for generations of Muslims to come.[32]

2.3 Arbitraging Classical Jurisprudence

We briefly review the classical juristic treatment of property and contracts in this section and that of the forbidden *riba* and *gharar* in Chapter 3.[33] We shall see based on those reviews that the essence of classical Islamic jurisprudence of financial transactions was simply to maximize efficiency and equity in exchange. However, understanding the mode of operation in Islamic finance (reviewed in Chapters 4–9) requires some familiarity with the classical juristic views and contract forms upon which the industry was built.

For instance, the most common vehicle for Islamic bond alternatives relies on securitization of the usufruct of an eligible property, such as land or machinery. Since the most common *sukuk* structure involves selling property and leasing it back, the property must satisfy all the classical conditions of eligibility for sale as well as lease. A special-purpose corporate entity is created to buy and lease back the property. That entity must therefore be eligible to take part in such contracts. Moreover, the special-purpose entity issues certificates (*sukuk*), the holders of which receive rental income in place of bond coupons. This imposes certain conditions on certificate holders' degree of ownership – through the SPV – of the leased assets, which ownership justifies the collection of rent. Thus, the process of Shari'a arbitrage curiously combines such classical conditions on property (and its transfer through nominate contract) with modern corporate forms that were adopted only recently in the Islamic world.[34]

Shari'a-Arbitraging Classical Property Law

For an object to qualify as property (*mal*) in classical Islamic law, it must satisfy two conditions: (1) possibility of physical possession and (2) having potential beneficial uses. The first condition makes it impossible to define intangibles such as knowledge and health as property. Thus, if one pays a doctor or teacher, one would pay them for their time (as proxy for effort and service) rather than for the goods they provide.[35] The second condition ensures the existence of considered value for objects deemed to constitute property. The two conditions were jointly crucial for determining legal status of various economic institutions and financial transactions.

Those conditions were invoked by the majority of contemporary jurists who deemed commercial insurance impermissible, based on their characterization of its "object of sale." In this regard, if the object of an insurance contract were defined as "security," with its premium viewed as price, the contract may have to be deemed valid. However, many jurists argued, "security" does not qualify as an object of sale, since it does not constitute a tangible good or service. Similarly, jurists adhering to classical taxonomies of property could not classify any disembodied contingent claims as eligible objects of sale. Instead, those jurists argued, the object of sale in a commercial insurance contract is the amount of money that the insured party receives in compensation for loss, which is uncertain. The contract thus characterized is deemed invalid based on excessive *gharar*, since the price (premium) is known, but the object of sale (paid claim) is uncertain, as discussed in Chapter 3.

Valued vs. Unvalued Property: Shari'a-Arbitrage Opportunity

Classical jurists further classified property (*mal*) according to a system of binary taxonomies, of which we list the most important three. First, they classified property as either (a) valued property (*mal mutaqawwam*), if it is privately owned and has permissible uses for its legitimate possessor, or (b) unvalued property (*mal ghayr mutaqawwam*). The second category includes two subcategories: (1) properties that are not currently possessed, for example, public property, and (2) properties with no permissible uses under normal circumstances, for example, wine and pork. Most contracts for total or partial ownership transfer (e.g., sale or lease, respectively) are permissible for valued, but not for unvalued, properties. This distinction allows lawyers in structured Islamic finance some leverage. For instance, if a company's assets included both valued and unvalued assets, they can either bundle the two sets of assets or disentangle them to maximize Shariʿa-arbitrage profits. For instance, classical jurists would allow a Muslim investor to buy a farm with pigs living on it, or a house with a wine cellar, but would disallow sale of those impermissible properties that are unvalued for Muslims. However, the use of SPVs – to which ownership rights of various assets are assigned – can allow non-Muslims to own the impermissible properties or sell them, compensating Muslim investors indirectly through inflated prices of the valued components of the bundled property being acquired.

Another source of Shariʿa-arbitrage profits stems from contemporary jurists' prohibition of owning companies with debt ratios exceeding a certain threshold. Islamic investment banks can transform a company from impermissibility to permissibility merely by structuring the leveraged acquisition through leases of eligible company property. In this regard, classical jurists differed over the eligibility of usufruct (*manfaʿa*) as unbundled property eligible for sale, thus accepting or refusing characterization of leases as sale of usufruct. Shafiʿi and Maliki jurists accepted usufruct as valued property, but early Hanafi jurists argued that the legal right to extract usufruct does not exist separately from other ownership rights, except by virtue of the lease contract. Differences in characterization of the same contract as sale of usufruct versus lease (*ijara*) can result in numerous differences in lease conditions, including rights and responsibilities for maintenance. Given a desired structure, those differences in characterization may require the creation of additional SPVs (in addition to the one that holds title for the master lease) to transfer those rights and obligations under classical *ijara* conditions back to their optimal parties under contemporary regulation and legislation. Another consequence of characterizing usufruct as a sale object – which has received surprisingly little attention in the literature – is the resulting sale repurchase characterization of sale-lease-back structures extensively used in structuring *sukuk* and corporate acquisitions in Islamic investment banking. We shall discuss various juristic and legal problems raised by this and similar sale-repurchase structures below.

Portability and Sukuk Structures

Second, properties are also classified into (a) immovable (ʿ*aqar*) properties such as real estate and (b) movable or easily transportable (*manqul*) properties. Legal status of a number of transactions is affected by the portability of property. For instance, reselling purchased items prior to taking possession is deemed by some Hanafi jurists to be valid for immovable objects but not for movable ones. This makes many Islamic financial transactions (e.g., *murabaha*-based mortgage financing) particularly cost-effective for banks whose offices may not be in physical proximity to the financed real estate. Another important distinction based on transportability of property pertains to preemption rights (*haqq al-shufʿa*, the right of first refusal to buy a neighbor's or partner's property at whatever price offered by third parties), which are deemed valid only for immovable properties. This also has potentially significant legal consequences for sale-lease-back-repurchase *sukuk* structures, wherein owners of adjacent properties may have preemption rights that are negated by the bond structure.

A third important consequence of the distinction between movable and immovable properties for structures of *sukuk* and other debt instruments is that movables (and hence more liquid) properties of a delinquent or bankrupt debtor are liquidated first, thus inducing implicit debt-subordination rules in asset-based structures. There are many other legal consequences of portability of property, including ineligibility of movable properties for easement rights, and their ineligibility for establishment as mortmain or trusts (*waqf*), which play an important role in contemporary structured finance and investment banking.[36]

Fungibility and Entitlement

Third, properties are divided into fungibles (*mithli*), measured by weight, volume, length, or numbers, and nonfungibles (*qimi*), each item of which is unique and differs in value significantly from other items of the same genus and kind. A main legal effect of this distinction is eligibility of fungible properties for establishment as liabilities, for example, as deferred prices, or objects of prepaid forward sales (*salam*). Many rulings also follow from divisibility and uniformity of fungibles, including the possibility of partial in-kind compensations. This distinction is important for various Islamic finance products, including trade- and lease-based *sukuk* commodity trade financing. In case of nondeliverability of goods in trade-based finance, liability for delivery of the goods (rather than their value) remains intact.

This may clearly induce significant transaction costs, for example, for contracts based on *salam*, wherein holders of the short position are required to deliver the commodities for which they contracted. On the other hand, in leases of nonfungible properties, destruction of the property would require compensation for its market value. In fact, Islamic finance structures utilizing *salam* and *ijara* stipulate sufficient conditions to ensure equivalence to the debt structures of conventional bonds (see Chapter 6 for details). However, unless and until specific lawsuits are brought to bear on this point, it is not clear how those conditions interact with stipulations that contracts are made in accordance with Shariʿa. At worst, such lawsuits may expose gaps in the legal structures that render the Islamic products substantially different from mimicked conventional counterparts (in which case those instruments would have been mispriced). More likely, highly publicized lawsuits may question the legitimacy of calling the products "Islamic," where the brand name rests on the assertion that classical Islamic contract conditions are observed.

Most significant for Shariʿa-arbitrage purposes is that rules of *riba* (increase in one of two exchanged items of the same genus and kind without compensation) do not apply to nonfungibles. Thus, while a usurer is not allowed to trade one ounce of gold for two, he is allowed to trade one nonfungible item (e.g., a diamond) for two diamonds, each of equal market value to the first. Moreover, a usurer may legally sell a diamond worth $10,000 today for a deferred price of $20,000 tomorrow. The buyer may have no interest in the diamond and sell it for $10,000 in cash. Thus, the usurer would legally collect overnight interest of 100 percent in a valid contract that avoids *riba* in form (though obviously usurious in substance). This clearly illustrates that the prohibition of *riba* cannot possibly be limited to questions of interest or exorbitant interest, since interest can be hidden in sales (as in *murabaha* and *tawarruq*), and it can easily be made exorbitant while avoiding the formalistic rules of *riba*.

Ownership

Article #125 of *Majallat Al-Ahkam Al-ʿAdliyya* defined owned property as "anything owned by a human being, be it a specified property, or usufruct of a property." Thus, Hanafi jurists, who did not recognize usufruct and disembodied legal rights as property, did recognize ownership thereof. Conversely, some properties (e.g., rivers, public infrastructure, parks) are not eligible for private ownership. Thus, attributes of properties and owned objects must be studied separately in terms of eligibility as objects of various contracts. Although the *Majalla*'s basic definition restricted ownership rights to humans, jurists have lately adopted legal entities such as corporations (genuine or special-purpose entities) and allowed them to own properties, usufruct, and legal rights.

Whereas modern legal scholarship recognizes ownership as a bundle of rights, which may be distributed across a number of human and corporate entities, classical jurisprudence recognized total and partial ownership only in terms of separating property (*raqaba*) from its usufruct (*manfaʿa*).[37] Thus, classical jurists defined ownership of the property and its usufruct as total, and ownership of one without the other as partial ownership. Participants at Al-Baraka's sixth jurisprudence symposium in 1990 utilized this separation of a property from its usufruct to devise an innovative structure in lease-to-purchase models for Al-Baraka lease-based home financing in London. Under the proposed structure, the property itself would be sold at the outset, thus allowing the eventual buyer of the property to receive title immediately. However, the bank would retain ownership of the usufruct, for which they can put a lien on the property and collect rent according to the contract. In recent years this structure has not been used. Instead, title is typically assigned to an SPV constructed for each lease-to-purchase transaction.[38]

Advances and Restrictions on Partial Ownership

Sale of usufruct, and its possible resale through subleasing, has given rise to time-sharing arrangements, primarily for housing units near the two holy mosques in Makka and Madina. Through this structure individuals own a multiyear right, for example, to usage of a housing unit next to the holy mosque in Makka for one week each year. The Saudi government did not contemplate the problematic prospect of selling land adjacent to the mosque (which may be needed later for expanding it). Instead, the government leased the land long term to a legal entity that in turn issued usufruct certificates (*sukuk al-manfaʿa*) that entitle their owners to extract usufruct during certain periods. This structure, with tradable usufruct extraction rights, was possible since all certificate holders would use the property in the same manner.[39] This is a positive example of using partial ownership provisions to develop a useful financial vehicle.

However, other useful implications of partial ownership were not developed in the industry. For example, within the conventional mortgage example of Chapter 1, contemporary jurists had the option to recognize partial ownership in more advanced terms than had their classical predecessors. Thus, instead of allowing mortgage financing only through credit sales (*murabaha*), lease (*ijara*), or full-fledged partnership (*musharaka*), they could have determined that liens (which could not have existed in premodern times, without searchable title databases) are a form of ownership right different from the classic *rahn* (pawning) contract. Indeed, modern legal dictionaries define a lien primarily as "a conveyance of title to property that is given to secure an obligation (as a debt) and that is defeated upon payment or performance according to stipulated terms."[40] Based on this legal definition and reality, jurists could have viewed the mortgagee's lien on property as a form of partial co-ownership for the mortgage period (until the debt is fully paid). Thus, conventional mortgages could have been characterized in terms of diminishing partnership between mortgagor and mortgagee.

Full development of this juristic argument is beyond the scope of this book and the author's area of expertise. However, we should note that such characterization of conventional mortgages would have led to more efficient outcomes that are deemed "Islamic." Of course, this efficiency would be attainable in part through elimination of Shariʿa-arbitrage opportunities, which have sadly become the main incentive mechanisms for Islamic finance. We shall discuss an alternative approach to Islamic finance in Chapters 3 and 4, based on understanding the prohibition of *riba* in terms of equity in exchange through marking to market within the framework of conventional financial tools such as mortgage financing. Within that framework the role of Islamic financial institutions would be acting as de facto financial advisers for their customers.

Trust, Guaranty, and Interest

Classical jurists recognized two types of property possession based on liability risk: possessions of trust and possessions of guaranty. Possessions of trust (which result, e.g., from deposits, leases, and partnerships) make the possessor responsible to compensate the owner only for damage to property caused by the trustee's own negligence or transgression. In contrast, possession of guaranty implies that the possessor guarantees the property for its owner against all types of damage, including damage not caused by the guarantor's own negligence or transgression. Classical jurists further stipulated that both types of possession cannot coexist. Thus, if a property is held in trust according to one consideration and in guaranty according to another, the possession of guaranty is deemed stronger and dominant, and rules of guaranty are thus applied.

Hence, most contemporary jurists have analyzed bank deposits thus: A classical depositary would hold the depositor's funds in trust. However, if the deposited amount is guaranteed, then the contract is no longer a valid deposit (*ida*ʿ), and many jurists have argued that the closest contract resulting in possession of guaranty is the loan (*qard*) contract (without specifying the metric used for determining contract proximity). Hence, if the principal is guaranteed by the bank, the depositor-bank relationship is viewed by those jurists as lender-borrower, and bank interest on deposits is thus viewed as forbidden *riba*. This line of reasoning was utilized in the conclusions of the fourteenth session of Majlis Majmaʿ Al-Fiqh Al-Islami held in Duha, Qatar, January 11–16, 2003. This logic was thus used to reject the earlier *fatwa* by Majlis Majmaʿ Al-Buhuth Al-Islamiyya of Al-Azhar, issued in Cairo on November 28, 2002, which had characterized bank deposits as legitimate investments paying fixed profit rates. El-Gamal (2003) proposed a synthesis of the two positions, which seems to have anticipated more recent developments of Islamic bank savings accounts that guarantee deposit principals in the United States and United Kingdom, as discussed in Chapter 8. Similar considerations of trust and guaranty are used by contemporary jurists to justify the Islamicity of *murabaha* financing, wherein the Islamic bank charges the same fixed interest rate it would charge on conventional mortgages, for instance. We shall discuss this issue in greater detail in Chapter 4.

Arbitraging Classical Contract Conditions

The most important condition for contract validity is mutual consent.[41] Toward that end, jurists enumerated some contract cornerstones without which this meeting of minds cannot be ensured. Those pertain to (1) parties of the contract, who must be eligible to conduct the contract, (2) contract language, and (3) object of the contract. A contract was not considered concluded if any of its cornerstones were violated. Conditions of contract conclusion may be grouped into conditions pertaining to (1) contracting parties (must be discerning, of legal age, etc.), (2) contract language (correspondence of offer and acceptance, elimination of unnecessary uncertainty), (3) unity of contract session, and (4) permissibility of object for specific contract.

A concluded financial contract was deemed valid if it avoided six main factors: (1) ignorance about object, price, time period, and the like, (2) coercion, (3) conditions contrary to a contract's nature (e.g., sale for a fixed period, or wherein the buyer 's use of his property is restricted), (4) unnecessary ambiguity in contract language, (5) encroachment on others' property rights, and (6) unconventional conditions that benefit one party at the other's expense. Returning to our mortgage example of Chapter 1, notice that jurists based their conclusion of impermissibility of conventional mortgage loans on the view that the mortgagor borrowed a certain sum of money (cash loan) and pays a larger amount in the future. However, in a classical loan contract (*qard*), ownership of the lent amount would be transferred to the borrower.[42] Thus, the jurists' analysis appears to be incoherent.

Conditions that reinforce the lender's ability to ensure debt repayment (including *rahn* or premodern mortgage of some property) were allowed. However, restrictive covenants that determine how the borrower must use the lent money (in modern mortgages, to buy a particular property that is then mortgaged) negate ownership of the money being transferred from lender to borrower. Hence, according to the classical rules of loan contracts, condition (3) is violated, and the mortgage loan's characterization in terms of premodern *qard* would be invalid. Development of a modern Islamic theory of secured lending is beyond the scope of this book. However, it is clear that Shariʿa-arbitrage opportunities in the mortgage market have been based on inaccurate matching of a contemporary term "loan" (especially within the context of secured lending) with the premodern *qard* contract. In this regard, we have seen in Chapter 1 that the OCC was convinced that Islamic mortgage alternatives through credit sale (*murabaha*) and lease (*ijara*) financing were in fact substantively equivalent to secured lending as practiced by banks. Instead of using this arbitrage opportunity to market costlier mortgages to Muslim customers, Islamic finance jurists and practitioners should have developed a new Islamic theory of secured lending, which is a modern transaction with no direct analogs in classical jurisprudence.

Another interesting subversion of conditions of classical contracts is evident in the structure of *murabaha* (cost-plus) financing. Classical jurists had stipulated that in *murabaha* and other "trust sales" (where buyer relies on seller revealing his cost), knowledge of the initial price is a condition of validity. When jurists adapted *murabaha* contracts for financial intermediation, they maintained this condition in terms of revealing the initial cash price paid for the property later sold on credit. However, it is clear that financial intermediaries, Islamic or otherwise, serve a primary function of transforming financial liabilities into financial assets, rather than trading in homes or automobiles. Thus, in *murabaha* financing, for example, and certainly in its *tawarruq* incarnation, the Islamic bank's business is in fact extension of credit, rather than sale of property. The requirement to reveal the initial price should translate in this financing framework into revelation of the bank's cost of funds and spread paid by the customer (e.g., we pay LIBOR + 100 basis points for those funds, and we charge you LIBOR + 200 basis points). This would in fact add economic value for Islamic bank customers, who are currently – at best – informed of their own cost of funds under truth-in-lending provisions such as regulation Z in the United States. In contrast, the current Islamic bank procedure is to reveal only the cash price, thus claiming that the difference between that cost and the credit price – which can be 200 percent or more of the original price, that is, the customer's cost of financing – is the bank's profit. This obviously does not satisfy the original intent in classical *murabaha*, since the relevant cost and profit margin for the financier are not in fact disclosed to the customer.

Other examples of arbitraging classical contract conditions to synthesize contemporary financial practices are provided throughout the book. In many cases, we shall argue that contemporary jurists' characterization of contemporary practices in terms of classical contracts may render those contracts invalid or defective according to the classical conditions. In this regard, it is worthwhile noting that Hanafi scholars distinguished between those two types of nonvalid contracts: defective (*fasid*) and invalid (*batil*). They ruled that a contract is invalid if it fails to satisfy any of its cornerstones, uses inadmissible contract language, or has an impermissible object (e.g., wine or pork). They further ruled that invalid contracts were not in fact concluded and thus may not result in any transfer of property, legal rights, and the like. In contrast, they deemed a contract defective if it satisfies all normal legal requirements but contains some illegal characteristics (e.g., a sale that contains excessive uncertainty, or *gharar*). Hanafis uniquely allowed certain types of defective contracts to revert to validity, for instance, if an appended corrupting condition that is not integral to the contract is removed. Moreover, they ruled that a valid contract to which defective conditions are appended remains valid, and the defective conditions are disregarded as nugatory provisions.

Thus, Hanafi and other jurists relied on nominate contract conditions to ensure validity of various contracts. Contemporary selective adherence to some of those conditions can be used for Shariʿa-arbitrage purposes, as shown in the previous examples and throughout this book. In contrast, contemporary juristic and economic analysis may be used to justify many contemporary financial practices. Within the latter context, study of classical nominate contracts would focus on their substantive economic content within their specific historical context, rather than outdated formal mechanics. To the extent that modern regulatory and legal systems share the main objectives of Islamic law (*maqasid al-Shariʿa*, of which the highest are preservation of life, wealth, mind, etc.), conventional modern regulatory restrictions can often be considered sufficient substitutes for classical contract conditions. To the extent that religious law aims to provide personal protections beyond the minimal ones afforded by secular regulatory frameworks, the substance of classical jurisprudence should be used to devise new individual protections within the modern conventional practice.

Arbitrage, Ruses, and Islamic Finance

Blind or cynical adherence to classical contract conditions may violate a fundamental principle in Islamic legal theory as expressed by Al-Shatibi:

> Legal ruses (*al-hiyal*) in religion are generally illegal. ... In this regard, legal provisions (*al-aʿmal al-Sharʿiya*) are not ends in themselves, but means to legal ends, which are the benefits intended by the law. Thus, one who keeps legal form while squandering its substance does not follow the law.[43]

However, there have been historical differences in opinion among jurists regarding some of the most obvious ruses, including some for which canonical prohibition is claimed. The most obvious example, discussed in detail in Chapter 4, is same-item sale-repurchase (*bayʿ al-ʿina*). Some jurists – including the prominent Hanafi scholar and judge Abu Yusuf – deemed this practice valid, and others including the Hanafi scholar Al-Shaybani and most Shafiʿi and Zahiri jurists deemed it valid but reprehensible, provided that the second sale is not stipulated as part of the initial contract.[44] In contrast, Maliki and Hanbali jurists ruled that the contract is invalid, since it is clearly a device for circumventing the prohibition of *riba* and based on two Prophetic traditions, the authenticity of which was accepted within those two schools but rejected by other jurists. However, some Hanbali jurists allowed a slightly more elaborate version of the same-item sale-repurchase procedure by including a third party. Contemporary *tawarruq* emerged based on this introduction of a third party.

We have thus seen that contemporary Shariʿa arbitrage is made possible mainly through the utilization of nominate contracts and selective application of their classical conditions. In this regard, the influential jurist Ibn Taymiyya noted in his lengthy discussion of nominate contracts that early Maliki and Hanbali jurists (including Imam Ahmad himself) had deemed contracts invalid if they could not find appropriate precedents permitting similar ones.[45] Traces of this original bias are readily seen in the use of classical nominate contract names in Islamic finance. Contemporary jurists assert that the default ruling in economic transactions is permissibility, but it is clear that many Muslims hold the view that contemporary Islamic financial contracts need to adhere to classical forms. Whether this bias is based on belief of impermissibility of transactions without classical precedents or merely aims to derive comfort from such precedents, it is likely that legal forms will continue to play a prominent role in Islamic finance for the foreseeable future. The best we can hope to accomplish in the short term is to ensure that this focus on form does not exclude consideration of economic substance entirely. Optimistically, one may hope that modest inclusions of substantive considerations in Islamic finance in the short to medium term may later serve as catalysts in long-term development of a viable modern Islamic jurisprudence.