

ISLAMIC FINANCE: PRINCIPLES AND STRATEGIES

Harvard Law School
March 6, 2018

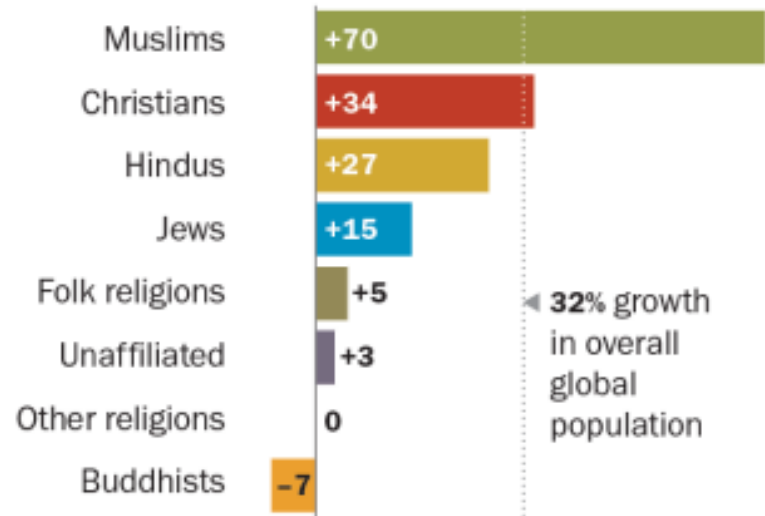
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Why Talk About Islamic Finance?

- Muslim population: 1.8 billion (2015) (Pew, 2017)
 - ▣ Number of Muslims expected to increase to nearly 3 billion in 2060.
 - ▣ Expected to grow as a percentage of population in every region, except Latin America and the Caribbean.

Muslims projected to be fastest-growing major religious group

Estimated percent change in population size, 2015-2060



Source: Pew Research Center demographic projections. See Methodology for details.
"The Changing Global Religious Landscape"

Figure 1:

SIZE AND GROWTH OF IBF BETWEEN 2007 AND 2016 AND FUTURE GROWTH PROSPECTS



NOTE: All the figures are in US\$ billion. For example, at the end of 2016, global size of the Islamic financial services industry was US\$2,293 billion, and this was due to an incremental increase of US\$150 billion over the previous year. Two estimates, i.e., US\$3,006 billion and US\$4,362 billion, are presented for the year 2020. The former is based on the assumption that the industry continues to grow at the current growth rate of 7% in the next four years; and the latter assumes that the industry will grow by compound annual growth rate of (CAGR) of 15.27% by 2020.

Geographical Footprint

- Middle East (strongest in GCC)
- Africa (majority Muslim and other countries, e.g., Nigeria, South Africa)
- Asia (strongest in Malaysia, Indonesia; Hong Kong sovereign sukuk)
- North America (relatively few products and services providers (funds, home finance, banking); many tailored for Muslim communities)
- Europe (e.g., UK sovereign sukuk; products and services advisors; several key cases involving Islamic Finance decided under England and Wales law)

Some Drivers of Growth

- Religion-based interest in developing Islamic products and institutions; alternatives to Western capitalism, communism and socialism.
- Demand among some Muslims for Shari'ah-compliant products and services.
 - Some demand by non-Muslims for ethical products and services.
- Petrodollars— high oil prices drove growth, particularly in wholesale segments.

Reemergence of Islamic Transactional Law and Practice

- Follows long period of decline of Islamic transactional law practice.
 - ▣ Most Muslim-majority jurisdictions apply secular law (to a large extent) to banking, finance, and commercial matters.
 - ▣ Only Iran and Sudan are wholly Islamic banking systems; other countries operate “dual” systems.
- Reemergence of Islamic banking and finance in the 1960s/70s.
 - ▣ 1960/61, *Iqtisaduna* (Ayatollah Mohammed Baqir Al Sadr (1935-80)).
 - ▣ Mit Ghamr Bank, Egypt (1963); Islamic Development Bank (1974/75); Dubai Islamic Bank (1975).
- Dow Jones Fatwa (1990s), opened way for Islamic equity investment.

Ecosystem/Participants

- Islamic Banks (fully fledged and windows)
- Insurance providers (takaful)
- Private equity firms
- Sovereigns (wealth funds, other)
- Multilateral development banks
- Retail and wholesale consumers
- Regulators
- Shari'ah Supervisory Boards and National Shari'ah Boards
- Standard Setters/Group Scholarship (e.g., AAOIFI, IFSB, OIC Fiqh Council)
- Lawyers

Legal Basics

- Religion, Morality and Law Inextricably Linked
- Sources of Islamic Transactional Law
- Affirmative Objectives, Encouraged Conduct, Key Prohibitions

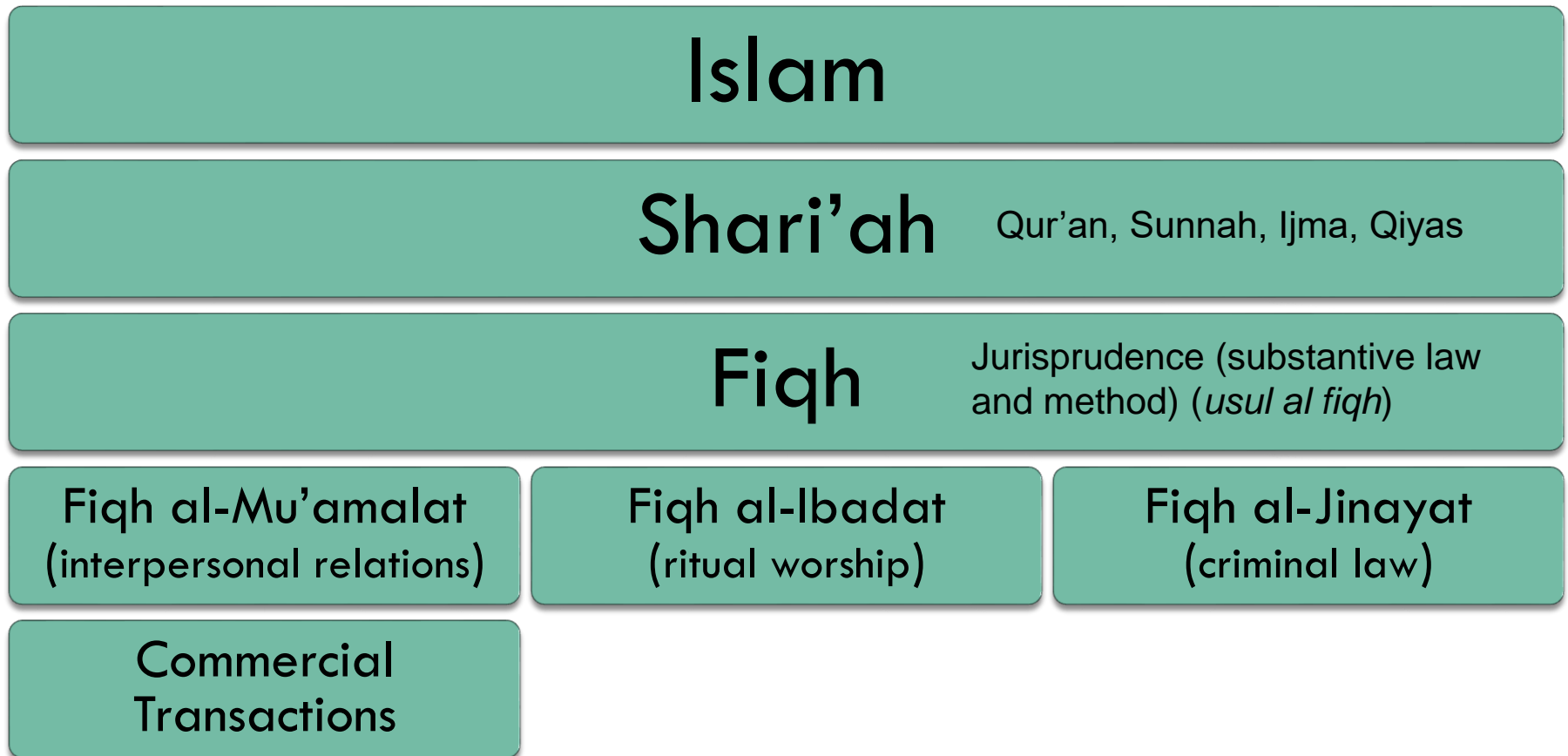
Morality (Religion) and Common Law...?

“I think it desirable at once to point out and dispel a confusion between morality and law . . . [A] bad man has as much reason as a good one for wishing to avoid an encounter with the public force, and therefore you can see the practical importance of the distinction between morality and the law. A man who cares nothing for an ethical rule which is believed and practiced by his neighbors is likely nevertheless to care a good deal to avoid being made to pay money, and will want to keep out of jail if he can.”

Islamic Context: Religion, Morality, Law Inextricable

“Law . . . in any sense in which a Western lawyer would recognize the term, is . . . *one of several inextricably combined elements thereof. Sharīʿa . . .* which is commonly rendered as ‘law’ is, rather, the ‘Whole Duty of Man . . . [A]ll aspects of law; public and private hygiene; and even courtesy and good manners are all part and parcel of the *Sharīʿa*, a system which sometimes appears to be rigid and inflexible; at other to be imbued with dislike of extremes, that spirit of reasonable compromise which was part of the Prophet’s own character.’”

Islam: Legal and Jurisprudential Framework*



*This is a simplified visualization.

Islamic Law: Sources, Sunni Schools

Primary Sources

- Qur'an
- Sunnah

Secondary Sources

- Qiyas
- Ijma

Four Prevailing “Schools” of Sunni Islamic Law

- **Hanafi** (Abu Hanifa Al No'man, 699-787)
- **Maliki** (Malik ibn Anas Al Asbahi, 710-795)
- **Shafi'i** (Muhammad ibn Idris ibn Abbas ibn Uthman ibn Al- Shafi'i, 768-820)
- **Hanbali** (Ahmed ibn Hanbal, 780-855).

Islamic View of Trade, Property, Wealth

- **Encourages trade and commerce, wealth, productive use of assets/capital (including human)**
 - “But let there be amongst you traffic and trade by mutual good will.” QUR’AN 4:29
 - “Allah has permitted trading and forbidden riba.” QUR’AN, 2:275
 - “O ye who believe! Devour not usury, doubled and multiplied; but fear Allah; that ye may (really) prosper.” QUR’AN 3:130
 - “No one consumes any food better than that which was earned by his own hands.” BADAWI, CONCISE PRESENTATION OF FIQH AT 456.

Islamic View of Trade, Property, Wealth

□ **Wealth belongs to God (Allah)**

- Protection of wealth as a “higher objective” of Shari’ah
- Values and Rules of Trade, Commerce, Contract, e.g.: principles of contract (good faith, fair dealing, disclosure); prohibitions of certain transactions (e.g., riba, highly speculative transactions/gambling)

□ **Recognition and protection of private property rights and its productive use**

- Including vis-à-vis the state, productive land use (e.g., revival of “dead lands”).

□ **Equality, Social Justice/Societal Considerations**

- Charity through zakat, sadaqah, waqf...

Wealth Generation, Preservation, Redistribution in Brief

Factors of Production/Bases of Entitlement to Profit

Property



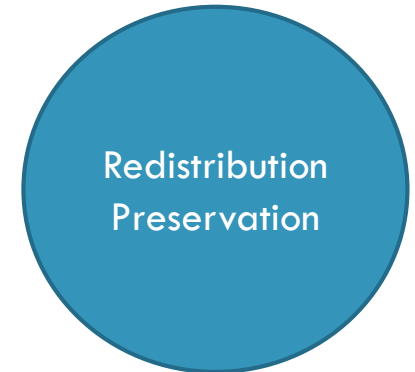
Capital



Labor



Zakat, sadaqa, waqf.
“compassion” loans, gifts,
productive actions, private
property, lenience in trading, no
riba, no gharar, etc.



Contracts/Root Transactions Basics/Market Conduct

- Contracts (formalities)
- Legal Boundaries/Prohibitions
- Principles of Market Conduct
- Root Transactions (trade)

Qur'an on Contracts (Executory): Writing Preferred, Fairness, Enforcement

“Oh ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing . . . Let him who incurs the liability dictate, but let him fear Allah, and not diminish in what he owes. If the party liable is mentally deficient, or weak, or unable himself to dictate, let his guardian dictate faithfully. . . . But if it be a transaction which ye carry out on the spot and among yourselves, there is no blame on you if ye reduce it not to writing. But take witnesses whenever ye make a commercial contract; and let neither scribe nor witness suffer harm . . .” QUR'AN, 2:282

Islamic Transactional Law: Outer Boundaries/ Key Prohibitions

- **Subject Matter of Transaction Must be Lawful.**
 - ▣ No alcohol, carrion, swine, idols (expanded today to include restrictions on tobacco, munitions, pornography-related investments/transactions).
- **Riba (excess/“interest”)** Excess, often described as “interest” is prohibited.
- **Gharar** (hazard, excessive risk, uncertainty) (Sunnah)
- **Maysir** (gambling)** (Qur’an))
- No sale of a thing not in existence or not owned (exception, salam sale)
- Evasive contracts and transactions scrutinized (and invalidated/modified as needed) by judicial authorities.

Riba

- Often referred to as “interest”, sometimes as “usury.” The concept is more expansive.
- Prohibition applies to currency and certain commodities
- Riba is “excess,” of two kinds:
 - ▣ *Riba al nasi’ah* (delay).
 - ▣ *Riba al fadl* (excess, e.g., exchange of like things in different quantities).
- Some reasons for prohibition (theories)
 - ▣ No counter-value
 - ▣ Keeps wealth in hands of few, to the detriment of many
 - ▣ Unjust enrichment
 - ▣ Market inefficiency (under- or over-valued exchanges)

Comparison: Views of Monetary Interest in Other Faiths, Secular Law

Judaism and medieval Christianity

- “You must not lend on interest (*neshekh*) to your brother, whether the loan be of money or food or anything else that may earn interest.” (23:19-20).

Hinduism

- “Vasishta, a renowned Hindu law-maker, created a special rule. “The rule forbade members of the two highest castes, Brahmanas (priests) and Kshatriyas (warriors), from being users, or indeed from lending at interest.” (Bhala, 673)

Secular Laws (United States)

- State usury laws

Gharar (Hazard/Excessive Speculation)

Sale of items not yet existing or whose existence or characteristics are not certain owing to the nature of the items or to contractual/transaction deficiencies. e.g.,

- ❑ Failure to identify subject matter of contract, or determine contract.
- ❑ Insufficient knowledge about price (or priced commodity), quantity, deferred period of delivery.
- ❑ Insufficient knowledge of the existence (inc. specific form, quantity, quality, etc.) or deliverability of a thing.

Examples: Rules and Principles of Market Conduct

- **Exploitation of information or market asymmetry/market manipulation prohibited** (e.g., sale by urbanite on behalf of Bedouin; arranging sales/representation of sellers in caravans before arrival to market).
- **Fraud or other misrepresentation prohibited.**
- **Amicable settlement preferred**
- **No monetary penalties** (interest/excess for late payment)
- **Profits gained through illegal means are to be disgorged**
- **Lenience in collecting debts; treatment of insolvent debtors.**

Some Islamic Root Transactions/Contracts and Business Relationships

Core Transactions/Contracts

- Sale (bay‘) (varieties)
- Currency exchange (sarf)
- Lease of property/services (ijarah)
- Loan (interest free) (qard)
- Istisna’ (commissioned manufacture)

Primary Business Forms/Relationships

- Partnerships (musharakah varieties; mudaraba)
- Agency (wakalah)
- Surety (kafalah)
- Trust (amanah)

Banking and Finance Without Interest...?

Home Financing Examples:

- Partnership (diminishing musharakah; financier and buyer purchase jointly, financier's interest diminishes with lease payments)
- Sale (murabaha; cost plus sale, installment payments)
- Lease ending in sale

Income-earning bank account (profit sharing investment account)

- Profit sharing investment account structured often as a partnership (mudaraba): bank as agent/services provider investing deposited funds and customer as capital provider earning returns (bearing risk of no returns and loss of principal).

Issues, Areas for Development, Controversies

- Key questions about whether some Islamic finance and banking products, services and practices are truly Islamic (raised by Muslims and non-Muslims).
- Needed further development of human capital (expertise, training, education).
- Calls for “standardization” across geographies.
- Calls for more effective, tailored regulation.
- Need for greater focus on governance and market conduct.
- Controversial (at notable cases) of legal disputes where basic Shari’ah *compliance* on the part of, e.g., Islamic banks, were seriously in doubt.
- “Shari’ah Risk”

Emerging Areas/Issues

- Increasing recognition of commonalities between socially responsible investment, Islamic finance.
- Emerging efforts to employ Islamic assets, structures and methods to advance public good, such as Sustainable Development Goals (SDGs).
 - Zakat funds to finance, Indonesia.
 - Multilateral-backed interest in and efforts to deploy waqf (Islamic trusts, zakat funds) to finance public objectives.
- Islamic legal rulings on cryptocurrency.

Questions/Reference Materials

- For questions or discussion, please contact Hdeel Abdelhady at habelhady@masspointpllc.com.
- Reference Materials (by Hdeel Abdelhady/cited above)
 - [Overview of the Global Islamic Finance Industry 2017](#) (introduction only).
 - [Dana Gas Declares its Own Sukuk “Unlawful”: Revisiting The Investment Dar Case and “Shari’ah Risk,”](#) MassPoint Blog (2017).
 - [Consumer-oriented insolvency risk allocation in Islamic retail profit sharing investment accounts,](#) Butterworths Journal of International Banking and Financial Law (2014).
 - [Specialized Insolvency Regimes for Islamic Banks: Regulatory Prerogative and Process Design,](#) World Bank Legal Review, Volume 5 (2013).
 - [Islamic Finance as a Mechanism for Bolstering Food Security in the Middle East: Food Security Waqf,](#) Sustainable Development Law & Policy Journal (2013).
 - [Islamic Law in Secular Courts \(Again\): Teachable Moments from the Journey,](#) International Law News (2009).

THANK YOU!

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