CHAPTER 17

Shari'a requirements for product development

17.1 Introduction

Islamic banking and financial products are developed by banking and finance product development teams, which necessarily means that the spirit of banking and finance is manifested in such products. The question arises as to whether Shari'a requirements are followed in their true spirit when structuring them. Institutions offering Islamic financial services are meant to ensure that all Shari'a requirements are observed in letter and spirit in developing and offering of Islamic financial products. It must, however, be emphasised that the application of Shari'a requirements to banking and financial products is a modern phenomenon. Notwithstanding this, the objective of Islamic financial product development, so far, has been to structure products that offer similar economic returns as conventional products. This has at times attracted a lot of criticism from those who would like to see the letter and spirit of the classical nominate contracts upheld. Consequently, one viewpoint suggests that the classical Shari'a requirements cannot be fully observed in the context of contemporary banking and finance, and hence there is a need to come up with a new model for financial intermediation that should aim to remain independent of the current banking and financial sectors. What does this mean in practice?

One way of implementing strict Shari'a requirements of classical nominate Islamic contracts are to develop specialised institutions offering Islamic financial products independent of banks. Such specialised institutions must not be deposit-taking institutions in order to ensure that the bankers' mentality is kept out of the Islamic financial business. One implication of this proposed model is that Islamic financial institutions would not be able to achieve economies of scale as experienced by deposit –taking commercial banks. However, lack of economies of scale can be compensated by the increase in profits accrued from trading activities specialised Islamic financial institutions would enjoy.

This chapter investigates how Shari'a requirements have in some cases been modified in the contemporary practices of Islamic banking and finance. The chapter attempts to get implications for a new model of Islamic finance.

17.2 The necessary Shari'a elements in product structuring

Shari'a dictates that in any structure, the underlying contracts must fulfil Shari'a requirements. Some of these requirements relate to the legal capacity of contracting parties; others relate to the contract itself being independent and not contingent on an extraneous occurrence. The subject matter of the contract also needs to be in line with the Shari'a and be considered permissible in itself and meant for permissible use. Having fulfilled all the structural requirements, the contract must meet, or at least not to be in conflict with, the objectives of Shari'a since an apparently valid contract may be misused to reach an evil end, or its implementation may result in causing serious harm. Therefore, by Shari'a it is necessary to distinguish between two elements in the validation of contracts: the form of the contract and its substance. The first relates to the structure of the contract, and the second relates to the essence, spirit and implications of the contract. Both are equally important and essential in product development. Many observers of the Islamic financial services industry, however, opine that this equation has not been fully observed in some of the products in the market. Given the huge emphasis on Shari'a compliancy in product development, as opposed to development of an Islamic financial system, the balance has obviously tilted in favour of ensuring that the form of contracts remains in compliance with Shari'a.

The following paragraphs posit the importance of not compromising the contract substance when structuring products, and identify the forms through which contract substance could be compromised and neglected in the product development process in the institutions offering Islamic financial services.

17.3 The relationship between form and substance in contracts

The maintenance of form and the negligence of substance can be a major problem in structuring and developing Islamic financial products. Careful study of the literature of Islamic law reveals that in contracts, the form is meant to protect the substance. In many fiqh applications, it is noticeable that schools of Islamic law have somehow compromised some aspects of the contract's form but never compromised the contract's essence or spirit.[1] This implies that jurists viewed form as something not meant for itself but rather to help protect the essence of contracts and agreements. Some modern practices of Islamic financial product development have implied the opposite: taking care of form and neglecting the substance of contracts. This negligence of contract substance is manifested in different forms as explained below.

17.4 Negligence of the contract substance by the deactivation of some contract rules

There is no doubt that the rules and conditions of contracts are meant to fulfil the contracting parties' needs in a just, positive and productive manner. This explains why parties in Shari'a are not allowed to make personal stipulations that could annul the contract rules.[2] Naturally, a contracting party will try to tip the scale to his favour even if it is at the expense of the other. However, in some cases we find, especially in uqud al-ez'an (contracts of subjection) where only one party of the contract formulates the contract, that some contracts rules are indirectly neutralised by adjusting some clauses or incorporating new ones as in the following example.

Example 1: Ijara muntahia bittamlik[3]

Being a contract of lease, Ijara Muntahia Bittamlik – or Islamic hire purchase – as used in Islamic banking is supposed to fulfil the following basic Shari'a structural conditions:

- The leased asset requested for financing is valuable from a Shari'a perspective and not declared by the client to be used for haram purposes. This would exclude, for example, financing clients in acquiring machineries that process tobacco products.

- The leased asset is clearly identified by the parties, and the rent is specified in the contract. If there is gharar (uncertainty) in the contract, then it must be minor since major gharar invalidates the contract.

- The leased property remains in the ownership of the lessor for the duration of the ijara period, and then it is transferred to the lessee by virtue of a completely independent contract, such as a sale or gift.

- The bank, as the lessor, bears all liabilities related to ownership, such as payment of property taxes and major maintenance required for keeping the asset valid for usage by the client.

- The lease period commences from the date on which the leased asset has been delivered to the lessee.[4]

These are the basic rules of ijara muntahia bittamlik, and theoretical investigation of any contract of ijara used by Islamic banks will prove consistency and full abidance. However, in order to ensure these products, based on this hybrid contract, are as close as possible to the conventional hire purchase contract, some clauses are added to this contract, (which could be seen as leading to the deactivation of some of these basic rules). Consequently, it is observed that such products behave more like financial products and less like a leasing business. The way the rental is calculated and decomposed has attracted criticism from some industry observers. However, this criticism may in fact be an offshoot to the general objection of using Islamic nominate contracts in modern banking and finance. Many advocates and practitioners of Islamic banking do not see any problem in this breakdown. The complementary rent represents any cost the bank as owner has incurred in the past ijara period. The cost includes taxes, insurance and major maintenance expenses. Although these are the responsibility of the bank as an owner, the bank after paying the costs claims the same back from the client under this clause by accruing it to the next ijara rental.

Although this may be seen contradictory to the spirit of ijara, the overall financial construct of ijara muntahiya bittamlik keeps the Islamic hire purchase products competitive in the market. However, the purists maintain their objection, considering it equivalent to paralysing the in-contract Shari'a rules pertaining to the liability of the owner in an ijara for property risks. According to this view, this practice of effectively shifting property risks to the lessee is especially critical since it brings this financing instrument closer to conventional financing after removing the justification for profiting which is based on the notion of "al-kharaj bi' daman"[5] (liability justifies the gain). The core difference between riba and trade remains the risk taking which is normally associated with trade. This risk taking is mitigated when the bank indirectly shifts the liabilities of the leased property to the client, and even in case of partial or total damage, it is the client who has to pay for it, although ex post in the form of future rental adjustments.

The variable element of ijara rental may give rise to uncertainty on the effective rental, which may fluctuate excessively, depending on the performance of an underlying benchmark like LIBOR. Islamic banks and financial institutions set a cap only on one end of this excessively volatile benchmark, i.e. its floor. However, a ceiling also needs to be set and capped at a certain figure in order to minimise

[1] For elaborated details on this matter see Abozaid Abdulazeem *Fiqh Al-Riba,* p 367.

[2] Ibn Qudamah. *Al-Mughni,* 4/167.

[3] This type of Ijara is not found in classical books of *Fiqh;* it is a creation of modern day jurist. It comprises two different contracts: contract of leasing *(ijara)*, and contract of sale *(bay')*. Bank promises the client that upon the successful completion of the Ijara, bank will sell the asset to the client at a nominal price, or will present it as a gift.

[4] Al-Shafi'i. *Al-Um,* 3/14; Ibn Abedeen. *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar)* 4/88; Al-Kasani. *Badai' Al-Sanai'* 5/67; 6/71; Al-Bahuti. *Kashaf Al-Qina',* 3/53; ; Al-Dasuqi, *Hashiyah* 3/143.

[5] *"Al-Kharaj bid Daman"* is orginally a Hadith narrated from the prophet (peace be upon him); however, it was recorded as a Fiqh maxim by Al-Suyuti in his "Al-Ashbah Wal Naza'ir", p 154.

The gharar involved and thus maintain the validity of the contract. Nevertheless, banks tend to only protect themselves from undesirable movements of the benchmark by capping the minimum amounts payable by their clients and have no desire to cap the maximum amounts payable. There is a need for greater regulatory intervention in such products to ensure that consumers' rights are well protected.

Moreover, the above deviation from ijara muntahia bittamlik rules manifests itself more blatantly when the asset leased in jiara muntahia bittamlik is originated from the same client. A client who needs cash or refinancing will be instructed by the bank to sell to it an asset or a common share thereof, then to lease it back from the bank through ijara muntahia bittamlik. The bank frees itself from all asset liability in the manner described above and the client repays the financed amount in form of rentals. This transaction has been widely used recently to enable banks to restructure non-performing debts in the wake of the financial crisis.

Thus, we see how some clauses in one contract can be neutralised by others, leading eventually to a completely new application of Islamic nominate contracts or their derivative forms. This requires very close scrutiny of legal documents from a Shari'a viewpoint before the products are offered in the market, and a regular Shari'a audit after the products have been marketed and sold. This close scrutiny of documentation in practice varies substantially and one may not be surprised to see some of the Islamic financial products based on the documents that are merely modifications of conventional products.

Example 2: Murabaha

The murabaha[6], is now used for a different objective altogether. It is used to provide clients with cash money with banks selling to them assets on a murabaha basis, payment to be made at a later date, then selling the same assets on the client's behalf for a cash price. Clients get the desired cash and remain indebted to the bank for the murabaha deferred price. Here we have two independent sale contracts, each of them lawful in itself but executing them consecutively is a cash financing technique which is effectively similar to conventional cash financing. Obviously, the result of this transaction is very different from the classical use of a murabaha sale contract, which has been transmuted from a sales contract to a finance contract. Murabaha in this transaction does not lead to real and perpetual ownership by the client. This is a deviation from the objective and substance of a classical murabaha, which has become a commodity financing instrument that helps clients own their desired assets.

Example 3: Wa'ad

Contemporary collective fatwas have helped structure many products that are essential for the operation of Islamic financial institutions. Consequently, the application of some of these products may have deviated from what they were originally designed for. A good example would be using for speculation what was designed for hedging.

Islamic finance has developed certain tools to hedge against some inevitable market risks. These tools include unilateral binding promises and tools whose underlying contracts are salam[7] contracts and urbun[8] sales. Apart from the Shari'a debate over the validity of these tools as hedging instruments in contemporary Islamic finance or the Islamic capital market, there is no assurance that such tools are in fact used for this specific purpose. It could very well be the case the users of such tools may use them for pure speculation as well, although speculation was considered an invalid objective in the creation of "Islamic derivatives".

Recently, one Islamic financial institution offered a product whose basic structure is as follows: The client opens a designated investment account with the bank. The bank operates the designated account in its capacity as investment manager. The investment manager then uses the amount deposited in the said account to purchase Shari'a compliant assets at prevailing market prices. In most cases the assets will be shares selected from an Islamic stock index. The client gives a unilateral promise to the bank to sell the shares at a predefined price called the "Settlement Price". The bank in return gives a unilateral promise to the client to buy the shares at the Settlement Price.

The settlement price relates to the performance of some specified underlying reference asset (the "Reference Asset", which could be an index) rather than the performance of the shares in the Islamic account. Thus, two scenarios are anticipated:

Scenario I: The performance of the relevant shares goes up more than the performance of the Reference Asset. In this case, the bank can purchase the relevant shares from the client at a price lower than the market value for such shares at that time. Thus, the bank would hold the client to his promise, while the client would not be interested in holding the bank to its promise as selling the shares at a value which is lower than the market value at that time would incur a loss.

Scenario II: The performance of the relevant shares is worse than the performance of the Reference Asset. In this case, the bank can purchase the relevant shares from the client at a price higher than the market value for such shares at that time. Naturally, the bank in this case would not be interested in holding the client to his promise while the later would hold the bank to its promise as he can then sell the relevant shares at a value higher than the market value for such shares at that time.

Therefore, in both scenarios noted above the client will sell the relevant shares to the bank for the settlement price as agreed on the basis of the performance of the Reference Asset. This sale is certain as it will serve the interest of either the bank or the client. The certainty of this sale makes the mutual promise to execute the sale binding on both parties and thus the promise will be tantamount to a forward sale contract, which may be considered as a breach of the Shari'a laws of a sale contract. Such products are abundant in the Islamic market and are seen as a way forward for bringing depth in Islamic investment banking.

The substance of this transaction is hardly distinguish-

[6] Murabaha in the banking application is a sale contract preceded by an agreement with client to buy the desired commodity from its supplier then to sell it to the client at the cost plus a mark up (murabaha).

[7] Salam is the sale of future delivered goods against upfront paid price.

[8] Urbun is a sale with the condition that buyer has the right to revoke the agreement in return of forfeiting the advanced down payment. If, however, the sale is concluded, then urbun advanced is deemed as part of the price.

able from that of any conventional derivative with the speculation element embedded therein; both contracting parties are speculating on the movement of the value of the Reference Asset, which is typically an index. It is very likely that such a structure will develop to involve financing the client for them to purchase the shares, then settling the deal with the adversely affected of the two parties paying the price difference to the other.

This transaction is indeed a smart application of the concept of promises, which has provided a great tool for risk management in Islamic banking and finance. The opposition to such products was significant in the beginning but now the market has realised their great utility and hence their use is on a rise.

17.5 Innovation in Islamic financial products: good or bad?

A direct examination of the Islamic banking market conditions, challenges and products identifies the following reasons for modern applications of the Islamic nominate contracts and their derivative forms.

1. The need to offer the same financing facilities as of conventional banks

Conventional banks conceptualised money as a commodity; therefore they have no problem in providing cash financing to clients at profit. This cash financing can take the form of personal loans, over draft facilities or refinancing, which all bear interest. However, since lending money on interest is prohibited, Islamic banks must offer these financing facilities by way of designing products that serve such purposes while remaining within the fold of Shari'a. Logically, the designed products would necessarily be modern applications of Shari'a principles and may lose their classical relevance and, in some cases, spirit. The resulting Shari'a compliant products rely on operations of buying and selling commodities, in some cases utilising controversial contracts such as bai' al-'ina (as in Malaysia) and tawarruq (mostly in the Middle East) sales as their underlying contracts[9]. In fact, a sale contract is designed to help people acquire commodities for their own use or to resell them and make a profit, but it is not designed to justify dealing in cash by simultaneously buying expensive and selling cheap. Such uses, and they are still limited in Islamic banking and finance, must be scrutinised with a view to develop an Islamic financial system that is an alternative to the conventional interest-based system and not merely a Shari'a compliant replica or extension of the latter.

2. The unwillingness to bear genuine property/ contracts risks

Being financial institutions, Islamic banks tend to avoid as much as possible the risk that is normally embedded in Shari'a contracts used in product structuring. This avoidance of risk has necessarily given rise to financial applications of Islamic nominate contracts. Their trade-oriented spirit has gradually weakened, which may be viewed as a defensive strategy of Islamic banking and finance. The application of ijara muntahia bittamlik in the manner described earlier is an example. The liability risk related to the ownership of the leased asset is effectively transferred from the bank to the client and thus the essence of the lease contract is distorted. Murabaha is another example when the bank frees itself from the liabilities associated with commodity murabahas. Neglecting the sale essence of a murabaha product is reflected when the murabaha client is appointed as the bank's agent to buy the commodity from its supplier, take delivery then deliver to himself, without the bank being responsible for even commodity defects or claims. In this scenario the bank's role is limited to only advancing money to the property supplier, thus mimicking the limited role of conventional banks. In this way, Islamic banks and financial institutions have lost a great opportunity to benefit from the profits related with trading.

3. Legal constraints facing the right application of Shari'a rules in products

In some countries the legal system stands as a stumbling block to the proper application of Shari'a rules required for product structuring in Islamic finance. Some Islamic banks for example find it inescapable to make the purchase appear in the client's name, because according to national legislation, banks are not allowed to trade in assets. Others are prohibited from leasing assets to clients and therefore they are left with no choice but to dodge and execute ijara in the form of sale. Imposing high taxes on registration of purchased assets is also a legal constraint as it eventually leads to increasing costs on clients when banks are commanded by law to register in their names what they buy before they sell to clients. Some banks tend to avoid payment of high taxes by reducing some necessary contractual steps or faking some contracts.

17.6 Are these reasons justifiable?

Development of Islamic banking and finance has been a difficult process in most of the countries where it has received acceptance and recognition. The reasons given above, therefore, can be justified in light of the historical path the practice of Islamic banking and finance has taken in the last 50 years or so. However, there is a need being felt to develop Islamic banking and finance as a distinct model of banking and finance, which must have its own value proposition in terms of social responsibility in addition to being Shari'a authentic. While the development of Islamic financial products and institutions in the past has a purpose and value, it will become increasingly difficult to justify a number of Islamic financial products going forward. Examples of such products abound in all segments of Islamic banking and finance. To name a few, products like Islamic credit cards, cash-based financing facilities (on tawarruq or 'ina bases), the types of sukuk with which banks like Goldman Sachs have been associated in the recent past, and structured products offered by a number of Western investment banks will require more research to increase Shari'a authenticity.

[9] For details on these sales see Abozaid Abdulazeem *"Contemporary Eina is it a sale or usury"* a book published in Arabic by Dar Al-Multaqa, Aleppo, Syria, 2004; Abozaid Abdulazeem. *"Contemporary Islamic Financing Modes between Contracts Technicalities and Shari'ah Objectives"*, Eighth Harvard University Forum on Islamic Finance, Harvard Law School – Austin Hall, USA, April 19-20, (2008).