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The Tension between Legal Values and Formalism in Contemporary Islamic Finance

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Contemporary Islamic finance has attempted to adapt to the realities of modern finance by recourse to several methods.[2] This paper focuses on one such topic, that of legal artifice or stratagem (*hila*, pl. *hiyal*).[3]

Let it be admitted at the outset that the claims of this paper about the dominance of *hila* in contemporary Islamic finance cannot be elaborated in length in the following few pages. However, this paper will achieve its goal if it draws attention to the possibility that the role of *hila* in contemporary Islamic finance is underestimated, and that the concept of *hila* may need to be widened to include several hitherto unquestionable modes of Islamic finance. In short, the goal of this paper is to reemphasize the question of whether the classical religious debate about *hiyal* needs to be reopened.[4]

THE DOMINANCE OF *HIYAL* IN CONTEMPORARY ISLAMIC FINANCE

The basic argument of this paper is that a financier should only act as *rabb al-mal* (finance provider). A financier is not a trader, a contractor, or a real estate developer, as Islamic financial institutions attempt to do nowadays in the three main finance modes of *murabaha* (commissioned sale with

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[2] See Frank Vogel and Samuel Hayes, *Islamic Law and Finance* (The Hague: Kluwer Law International, 1998), 34-41.
[3] For further discussion of *hiyal*, see Joseph Schacht, introduction to *An Introduction to Islamic Law* (Oxford: Clarendon Press, 1964), 78-84; N. J. Coulson, *A History of Islamic Law* (Edinburgh: Edinburgh University Press, 1994), 100,139-141; Vogel and Hayes, *Islamic Law and Finance*, 39-41,143,183; and Wael Hallaq, *A History of Islamic Legal Theories* (Cambridge: Cambridge University Press, 1997), 173,185-187.
[4] Vogel and Hayes, *Islamic Law and Finance*, 40.

markup), *istisna'* (commissioned manufacture), and *ijara* (lease). A financial institution may only assume the role of trader or manufacturer or real estate developer under the guise of *hila*. This argument is based on three observations: prearrangements with third parties, the intention of the parties, and the complexity of structures and multiplicity of documentation.

Let us first consider the counterargument that an Islamic bank is a *mudarib*, that is, an "active partner" receiving customers' deposits to invest in trade, real properties, or any other lawful investments. But an Islamic bank is only a *mudarib* vis-à-vis the depositors, and is a financier as far as its customers are concerned. This is evidenced by the fact that an Islamic bank cannot trade directly with its customers without the mediation of a third party in the two finance modes of *murabaha* and *istisna'*, be it a third party supplier of goods as in *murabaha* or a third party contractor or manufacturer as in *istisna'*. It is the third party factor that reveals the true function of the Islamic bank as financier. In *ijara* the third party does not play a major role because the leased asset is usually purchased from the customer and leased back to him (with the title to be ultimately transferred back to him). However, the *hila* here is perhaps more transparent, as the transitory ownership of the bank is only superimposed on the financing deal. Any attempt to overshadow the role of financier under the cover of trade, manufacture, or real estate development may be simply *hila*.

In addition to prearrangements with third parties, the intention of the parties may be another indication of *hila*. In ordinary, classical *murabaha* and *istisna'*, the seller does not necessarily acquire or manufacture the goods for the purpose of credit sale. In contemporary "banking *murabaha*" or "banking *istisna*," the seller *necessarily* acquires the goods or has them manufactured (through third parties) for the very purpose of credit sale. The extension of credit is the true intent of the parties, not simply trade or manufacture. Likewise in *ijara*, the intent of the parties is to extend credit to the customer by superimposing the lease on the transaction. We will discuss later the justifications for such superstructures, but two brief notes may be made in passing. First, suffice it to note that the profit in *murabaha* and *istisna'* and the rent in *ijara* is invariably based upon the money market rate, not as a "temporary index," but as an actual and inevitable indicator. Second, the existence of credit sale as a mode of finance in medieval Islam does not necessarily mean that Islamic law has to live with *hila* forever. It must be acknowledged that *hila* did exist in at least some schools of Islamic law since the early stages. This does not, however, ensure that *hila* can cope with the complexities of modern finance.[5]

[5] See Vogel and Hayes, *Islamic Law and Finance*, 139. Although *hiyal* existed in theory in the Hanafi and Shafi'i schools, their role in the legal practice of the classical

The third indication of *hila* is the existence of complex structures and multiple documentations. *Murabaha* is based on the purchase of the goods by the financial institution from a third party supplier, usually preceded by an order and promise to purchase from the customer, and frequently coupled with agency from the purchaser to the financial institution to sell the goods to another supplier after selling them to the customer. The underlying structure in *istisna'* is the technique of *istisna' muwazin* (back-to-back *istisna'*), which depends on third party contractors or manufacturers. *Ijara*, in its turn, is structured on the basis of purchase of the leased asset from the customer and leasing it back to him, whereby the customer ultimately re-acquires the leased asset upon full payment of liability. Even when the leased asset is purchased from a third party, the underlying transaction is not a lease but pure financing, especially in view of the fact that the rental payments are directly determined on the basis of market lending rates, and that the lease ends in ownership. To address the issues of maintenance and insurance as obligations of the lessor, the concept of "service agency" effectively transfers such liabilities to the lessee.[6] In contrast to a simple lease, an *ijara* transaction would require no less than four separate agreements: one for purchase, one for lease/lease-back, another for service agency, sometimes another for put/call options, and a final one for transfer of ownership to the customer upon the end of a lease. The bank accordingly assumes all the roles of purchaser, lessor, principal, and seller in one single transaction.

Some *hiyal* are so simple that they are now fully integrated into contemporary Islamic finance and are no longer questioned. This is the case with simple *murabaha*, such as the resale of vehicles or consumer goods, when the customer acquires ownership of the goods. However, other applications of *hila* are not so simple and are extremely

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period is far from certain. See Nicholas Dylan Ray, "The Mediaeval Islamic System of Credit and Banking: Legal and Historical Considerations," *Arab Law Quarterly* 12, no. 1 (1997): 43-90. Ray states on page 47: "In fact, despite the acceptance of *hiyal* by the Hanafi and Shafi'i schools, there is little reason to believe, on the basis of documentary evidence, that *hiyal* played a major economic role in medieval Islamdom, at least in relation to interest-bearing loans, most of which seem to have been contracted (in strict opposition to Islamic law) between Muslims and individuals of other religions, or between bankers and desperate governments, and which loans did not depend on *hiyal*." See also page 59: "If it can be demonstrated that interest-bearing loans were of little economic consequence in their own right, it would be apparent that the *hiyal* permitting their use were equally unimportant. This question of the economic role of the *hiyal*, and of interest-bearing loans in general, though difficult to answer, is of utmost importance for the comparative study of economic history in medieval Europe and the Near East."

[6] For detailed discussion of the various mechanisms of contemporary Islamic finance, see Vogel and Hayes, *Islamic Law and Finance*, 139-149, 182-193, 212-214.

controversial. For instance, in *tawarruq* (cash seeking) *hila* finds one of its most controversial applications. Pursuant to an order and promise to purchase from the customer, the bank purchases a commodity from a broker and sells it to the customer by way of *murabaha*. The customer immediately appoints the bank as agent, or "messenger," to sell the commodity to another broker (prearrangement between the former and the latter broker being already in place). No commodities are actually changing hands between the brokers, the bank, and the customer. No payments are made by the bank to the first broker or any supplier when the bank "purchases" the commodities, nor are any payments made by the second broker or any ultimate purchaser to the bank when the bank finally "sells" the commodities. In short, only book entries (and brokerage) are at work, and the process ends in the customer receiving cash. Normally the only two justifications for any purchase transaction are *qunya* (acquisition) and *istirbah* (profit seeking). Neither is intended by the customer in *tawarruq*. Only cash is at issue and the purchased commodity is totally irrelevant.[7] The essential safeguard of *daman* (contractual liability), as shall be explained below, is totally absent from such a transaction. Only a fictional, transitory pre-sale *daman*[8] is created, but the purchaser is left with cash and liability for premium over cash, without any actual seller's liability.

There has recently been some focus on *tawarruq*, perhaps due to its starkly fictional structure. However, such a focus may lead to distraction from the overall fictional picture, and from the issue of whether or not *tawarruq* is simply an extreme application of *hila*. *Hila* may be an alarming sign of predicament in the legal system.[9] It may indicate an inability to reach beyond the form, a failure to grasp the essence of the legal rule, and a lack of thinking in light of general principles.[10]

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[7] See on *tawarruq*, Vogel and Hayes, *Islamic Law and Finance*, 102, 141-143. *Tawarruq*, as currently practiced by Islamic banks, has been declared unlawful by the Fiqh Academy of the Muslim World League in its 17th Session convened from 19 to 23/10/1424h.

[8] See note 17.

[9] See Lon Fuller, *Legal Fictions* (Stanford: Stanford University Press, 1967), 7: "[T]he fiction represents the pathology of the law. When all goes well and established legal rules encompass neatly the social life they are intended to regulate, there is little occasion for fictions. . . . Only when legal reasoning falters and reaches out clumsily for help do we realize what a complex undertaking the law is."

[10] The distinction between the so-called "lawful *hiyal*" and "unlawful *hiyal*" seems to originate in a confusion between legal fiction as a technique for the development of the law (*fiction de droit*; *présomption de droit*), and stratagems devised for the sole purpose of circumventing the law (*simulation*; *suriyya*). See, Satoe Horii, "Reconsideration of Legal Devices (*Hiyal*) in Islamic Jurisprudence," *Islamic Law and Society* 9, no. 3 (2002): 312-357.

SHIFTING THE BURDEN OF PROOF IN *MUDARABA* AS AN ALTERNATIVE TO *HIYAL*

One of the suggested alternatives to *hiyal* is the shifting of the burden of proof to the *mudarib* (the working, or active, partner, that is, the customer as distinguished from the bank), in the sense that the *mudarib* becomes required to prove that the loss was not due to his own misconduct or negligence.

To begin with, the financier in *mudaraba* (capital-labor partnership) is accurately called *rabb al-mal* (the capital provider).[11] The nature of *mudaraba* as a genuine finance mode is shown at first sight by its simple structure. No orders, promises, third parties, or agents are called for. No side letters or convoluted documentation is needed. What is needed is one simple agreement between *rabb al-mal* and the *mudarib*. The former is making available to the latter a certain amount to finance a certain activity to be undertaken by the *mudarib* for a certain period, and the ratio of distribution of profits, if any, is set out.

Mudaraba has long since been recognized as the only acceptable characterization of investment accounts. Here, the depositor is *rabb al-mal* and the bank is the *mudarib*. However, Islamic financial institutions have always avoided *mudaraba* as a finance mode because of its risks, as the *mudarib* is not liable for the profit or even the principal, except in the case of negligence or misconduct.

Several suggestions have been advanced to mitigate the risk of *mudaraba* and adapt it to the modern financial system.[12] The concept of the "public, or mutual, *mudarib*" has been suggested by analogy to the "public, or mutual, manufacturer" who is held liable even without proof of negligence or misconduct for materials entrusted to him by his customers.[13] But such a concept is only useful to approach the bank-depositor relationship issue and cannot be generalized to include every *mudarib*.

Perhaps the best solution thus far suggested to actualize *mudaraba* as the most important channel of Islamic finance has been reached by approaching the problem from the burden of proof angle.

From this standpoint, the age-old principle that the *mudarib* is only liable in the event of negligence or misconduct is still observed in view of its significance as one of the cornerstones of the whole edifice of Islamic

[11] For more on *mudaraba*, see Vogel and Hayes, *Islamic Law and Finance*, 110, 130-139, 193-195.

[12] On the potential of insurance in this respect, see Ibid., 150-154.

[13] See 'A'isha al-Sharqawi al-Maliqi, *al-Bunuk al-Islamiyya* (Casablanca: Al-Markaz al-Thaqafi al-'Arabi, 2000), 325, 343; and Vogel and Hayes, *Islamic Law and Finance*, 132.

finance. However, it is the onus of proof that has been shifted. It is the *mudarib* who would be required to prove that the loss of profit or principal was not due to his negligence or misconduct. In this way, the risk of *mudaraba* insofar as the Islamic bank is concerned is lessened to a great extent.

Abu Dhabi Islamic Bank has been among the leading Islamic Banks in reintroducing *mudaraba* into Islamic finance. Its *shari'a* board has already approved the shift of the burden of proof in *mudaraba* and several full fledged *mudaraba* agreements built on this concept have been executed and implemented.[14] However, shifting the burden of proof in *mudaraba*, important as it is, still leaves many cases unsolved, especially in consumer-related finance.

THE TECHNIQUE OF *HIYAL* IN LIGHT OF THE *MAQASID* VALUES

If it is agreed that there are some general principles (*maqasid*) underlying the entire Islamic law of financial transactions (*fiqh al-mu'amalat*), then the principle of *daman* (liability or contractual liability) is one of the most fundamental of such principles.[15] This principle seems to require the presence of "justified liability" and the absence of "unjustified liability" in every transaction in order to exclude both *riba* (usury) and *gharar* (uncertainty). Thus, sale (including a premium over cash in credit sale) is lawful due to the justified liability of the seller for defects and "vindication" (*istihqaq; istirdad; darak*; third-party claims) to counterbalance the purchaser's liability to pay the price. Interest on credit is unlawful in view of the unjustified liability of the borrower to pay back principal and interest without a corresponding liability on the part of the

[14] Shifting the burden of proof in *mudaraba* may also be a solution to the problem of security of deposits against losses, especially in countries where Islamic banks are not exempted from such requirement. See, al-Maliqi, *al-Bunuk al-Islamiyya*, 633.

[15] See Peter Stein and John Shand, *Legal Values in Western Society* (Edinburgh: Edinburgh University Press, 1974), 258: "Legal principles are the meeting-point of rules and values." See on *maqasid*: al-Shatibi, *al-Muwafaqat* (Cairo: Al-Maktaba al-Tijariyya al-Kubra); Ibn 'Ashur, *Maqasid al-shari'a al-islamiyya* (Amman: Dar al-Nafa'is, 2001); al-Raysuni, *Nazariyyat al-maqasid 'ind al-imam al-shatibi*, 4th ed. (Riyad: Al-Dar al-'Alamiyya li-l-Kitab al-Islami, 1995); Ibn Zughayba, *Maqasid al-shari'a al-khassa bi-l-tasarrufat al-maliyya* (Dubai: Markaz Jum'a al-Majid, 2001); al-Alim, *Al-Maqasid al-'amma li-l-shari'a al-islamiyya*, 2nd ed. (Riyad: Al-Dar al-'Alamiyya li-l-Kitab al-Islami,1994). On the general principles and "internal structure" of Islamic contracts and commercial law, see Vogel, "Ijtihad in Islamic Finance," *Proceeding of the Fifth Harvard University Forum on Islamic Finance* (Cambridge: Harvard University, 2003), 122.

lender like that of the seller. *Gharar* is likewise unacceptable because of the lack of liability due to uncertainty. The purchaser of the "stray camel" would be liable for the price while the seller would not be liable for delivery, defects, or third-party claims.[16]

Most of the basic issues of *fiqh al-mu'amalat* seem in the final analysis to revolve around the concept of *daman*.[17] Issues such as the unacceptability of the *mudarib*'s liability for the loss of the *mudaraba* capital, the rejection of the partner's liability for his partner's share or the illegality of the lessee's liability for loss of the leased asset (absent negligence or misconduct) are all apparently related to the idea of *daman* in order to guard against the transaction turning into a guaranteed premium over principal. Third party guarantee of the profit of the *mudaraba* or the partnership is not acceptable for the same reason. The whole concept of profit and loss sharing may be ultimately based on the principle of *daman*, as each party is liable for loss (justified *daman*), and neither is liable for the other party's profit (unjustified *daman*). Likewise, the central issue in *gharar* is perhaps *daman*, as *gharar* involves the lack of *daman*, here "justified *daman*," due to the uncertainty of the principal obligation. In other words, *daman* is generally a *shart* (prerequisite) in sale and lease but a *mani'* (impediment) in *mudaraba* and partnership.

As a matter of fact, even a quick survey might show that most *hiyal* in contemporary Islamic finance are intended to introduce some *daman* such as when the Islamic bank acts as a seller in *murabaha*, a contractor in *itisna'* or lessor in *ijara* to create some liability, albeit often transitory, remote, and fictional, on the part of the bank. An illustration from practical personal experience may be in order. A client approached an Islamic bank for automobile finance. The transaction proceeded like any car *murabaha*. The client had already picked the car, identified the seller (technically speaking, the "original seller" or "the supplier"), and negotiated the purchase price with him. The bank signed a purchase contract with the seller, paid him the price, and signed a credit sale contract with the client. But the client later came to know that the car had been stolen and the seller apparently left the country. Had the transaction been a car loan, the client

[16] See Vogel and Hayes, *Islamic Law and Finance*, 100.

[17] The rules relating to *daman* are prominent in the literature of *qawa'id* (general rules, often translated as "maxims"). Many of the *qawa'id* may actually be maxims, but there are certain genuine general principles among them, such as *al-kharaj bi-l-daman* (profit goes with liability) and *al-ghurm bi-l-ghunm* (loss, that is, liability, goes with gain). See Ibn Nujaym, *al-Ashbah wa-l-naza'ir* (Beirut: Dar al-Kutub al-'Ilmiyya, 1999), 127-128; al-Suyuti, *al-Ashbah wa-l-naza'ir*, vol. 1, (Beirut: Dar al-Kutub al-Ilmiyya, 1999), 295-296; Salim Rustum Baz, *Sharh al-majalla*, (Beirut, 1986), 56-58. On *qawa'id*, see generally Vogel, "Ijtihad in Islamic Finance," 121-122, and Vogel and Hayes, *Islamic Law and Finance*, 35, 72.

would not have even thought of complaining to the bank. But the client knew well her rights as a purchaser (not just a borrower) and demanded that the bank assume its responsibilities as a seller. The issue was submitted to the bank's *shari'a* board, which then ruled that the bank was liable for third-party claims (*daman al-istihqaq*). The outstanding *murabaha* installments were accordingly waived and the paid installments refunded to the client in full. This is perhaps a clear illustration of how Islamic finance is different from conventional finance. It was the client who identified the car and the seller, and negotiated the whole purchase deal with him. The bank was a financier in the true sense of the word and only a seller in a very technical sense, by virtue of the two contracts of purchase and sale it signed. But why should a financier be liable for third-party claims against its customer's cars? As our example shows, the formalities of purchase and sale are only technical implementations of the principle of *daman*.

However, more often than not, the techniques overshadow the value. The case discussed above is exceptionally clear due to its unusual circumstances. In the vast majority of cases, the value of *daman* in the sense of "justified liability" on the part of the financial institution gives way to *daman* in the sense of "unjustified liability" on the part of the customer. The dominance of casuistic reasoning by the maxim that "every loan that attracts a benefit is usurious (*riba*)" necessitated the avoidance of interest-taking by introducing some *daman* into the transaction. Thus, the devices of *murabaha*, *ijara*, and the like came into existence in order to ensure some liability on the part of the financial institution. But such liability is usually mitigated to the greatest extent possible by effect of various waivers, disclaimers, and other arrangements, whereas the customer's liability is invariably confirmed. The devices now function to undermine the very values they are supposed to safeguard.[18]

[18] *Daman* in the sense of contractual liability should be clearly distinguished from the concept of *daman* as risk of loss, risk of ownership, or liability in the sense of pre-sale liability for loss, which may be confusing in this context. The value of *daman* is perhaps undermined by shifting the emphasis from the post-sale seller's liability to the so-called pre-sale liability for loss. The widely accepted argument that the pre-sale liability for loss is the only *daman* required in *murabaha* to justify the profit and exclude *riba* seems to emphasize risk for the sake of risk as it overlooks the fact that such liability is of no practical significance inasmuch as no counterparty is drawing any benefit from such liability or risk. This argument also seems to mistake an issue of *gharar* for one of *riba*.

CONCLUSION

Hila is defeating the very purpose of Islamic law by uprooting a great legal system from its ethical foundations and unjustifiably transforming an originally equity-based finance system into a debt-based one. It converts transactions whereby the financier should assume a certain minimum share of risk into debt-based financing and guaranteed profit clothed in the dress of a sale or lease. Even aside from its ethical vagueness and irrationality, *hila* is casuistic and its applicability is limited by its very nature. Therefore it cannot cope with the complex issues challenging Islamic finance today. Islamic finance will not be able to bear long under the pressure of so many complex and proliferating issues through a reliance on *hila*. Sooner or later, *hila* leads to a dead end.

Awareness of the deadlock into which *hila* is leading Islamic finance is now growing. The call is steadily rising for the elimination of some of its most extreme applications, such as *tawarruq*. But if *murabaha*, heavily based on *hila* as it is, constitutes in many cases the greatest share of Islamic banking transactions, then those issuing such a call must come to grips with the fact that *tawarruq* is only a variation on *murabaha* and that the existing methodology cannot give more than it already has.

Islamic finance should perhaps focus more on its underlying values and less on cumbersome, convoluted techniques. Reasoning by *maqasid (al-ta'lil al-maqasidi*), that is, by general principles derived by induction from individual texts and *'ilal*[19] instead of directly reasoning by such texts and '*ilal*, has a potential that is yet to be explored. Such reasoning may remain faithful to the ethical foundations of the *shari'a* without losing sight of the complexities of modern life. For instance, more attention should be given to the principle of *daman*, as briefly illustrated above, instead of the focus on "every loan that attracts a benefit is usurious." Perhaps a loan becomes usurious not simply because it attracts a benefit, but because the "unjustified *daman*" on the part of the borrower is not counterbalanced by any *daman* on the part of the lender. However, an elaborate discussion of *maqasid* is beyond the scope of this paper. Suffice it to note in conclusion that recourse to *maqasid* analysis may be the only viable alternative to *hiyal*.

To conclude, it may be apt to quote a proposal made in a similar context:

> I propose that this skeleton in the family of the law be taken from its closet and examined thoroughly. After that examination we may decide what we ought to do with it. At

[19] Plural of '*illa*, or "ratio legis."

> any event I am convinced that keeping it in the closet is both dangerous and unbecoming.[20]

[20] Fuller, *Legal Fictions,* 4-5.